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STATE TAXATION OF INTERSTATE COMMERCE AND WORLDWIDE CORPORATE INCOME

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

S. 983

A BILL TO REGULATE AND FOSTER COMMERCE AMONG THE STATES BY PROVIDING A SYSTEM FOR THE TAXATION OF INTERSTATE COMMERCE

S. 1688

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO CLARIFY THE EXTENT TO WHICH A STATE, OR POLITICAL SUBDIVISION, MAY TAX CERTAIN INCOME FROM SOURCES OUTSIDE THE UNITED STATES

JUNE 24, 1980

PART 2 OF 2 PARTS
(Communications)

Printed for the use of the Committee on Finance

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Statement of the Honorable Herman E. Talmadge (D-GA)
before the Subcommittee on Taxation and Debt Management
Generally, Committee on Finance, United States Senate
June 24, 1980 Statement on S. 1688

Mr. Chairman, as a co-sponsor of S. 1688, which would eliminate the worldwide combined reporting system from the states method of determining corporate tax assessments, I am pleased to lend my wholehearted support for its passage.

This is not a new matter to come before the Congress. In 1969 a bill was reported out of the House Judiciary Committee passed the House but was not enacted. This would have resolved the problem presented by S. 1688 and would have mandated a greater degree of uniformity in the rules for state taxation of corporations.

Other legislation introduced in an effort to resolve the multitude of interstate and international tax problems were H.R. 11798, 89th Congress (1965), H.R. 16491, 89th Congress (1966), H.R. 2158, 90th Congress (1967).

H.R. 2158 passed the House by a wide margin but died in the Senate.

In February of 1969 our colleague here on the Finance Committee, Senator Ribicoff, introduced S. 916, 91st Congress, which included the language of H.R. 2158 that had passed the House.

In his opening remarks on the occasion of introducing S. 916 (Cong. Rec. 2/4/69 115 Cong. Rec. 2597) he stated:

> "A major objection to the unitary concept is that the California practice requires the inclusion in unapportioned tax base of "foreign source income" which is earned in countries outside of the United States and which is not even included in the measure of the Federal income tax imposed by the United States. For example, under the California practice, a Connecticut corporation -- with an affiliate in California and other affiliates in such countries as Holland, France, Japan, and so forth -- is required to include in the measure of the California tax the income of the foreign

> affiliates as well as the income of the California affiliate and the Connecticut affiliate. Besides being highly inequitable, this practice conflicts directly with international tax policies of the Federal Government and, if permitted to continue, can result in a situation in which various States of the United States are formulating their own international tax policies without taking into account the international trade policies of the Federal Government (underscoring supplied).

The history of worldwide combined reporting shows a continuous need to resolve a long standing problem by enacting Federal legislation setting standards for taxation of foreign source income. Thank you, Mr. Chairman.

Statement of the Honorable David E. Satterfield (D-VA) before the Subcommittee on Taxation and Debt Management Generally, Committee on Finance, United States Senate June 24, 1980 Statement on S. 1688

Mr. Chairman, this piece of legislation, S. 1688, is comparable to H.R. 5093 and H.R. 5076, the former of which I introduced in the House of Representatives in 1979. This particular piece of legislation would fulfill part of the recommendations made by the House Task Force on Foreign Source Income of the Committee on Ways and Means, which report was dated March 8, 1977.

Relative to the issue of state taxation of foreign source income, the House Committee on Ways and Means stated the issue as follows:

> "Although a larger controversy exists of the states jurisdiction to tax income and the need for uniform rules among the states, the basic issue before the task force was whether the Federal government should prohibit states (a) from taxing foreign source income directly; or (b) from taking into account foreign source income from the unitary method."

For federal income tax purposes, the apportionment formula is not use to decide income for costs between United States and foreign countries. Instead, income for costs are allocated between related companies using the criterion of what the costs and price would be between these parties if they were independent parties dealing at arm's length.

The Task Force recommended, which report was later adopted by the full Committee on Ways and Means, that income of foreign affiliates should not be subject to state taxation until such time as that income is subject to Federal income tax.

I have taken the liberty of attaching hereto pages 25 through 30 of the committee print from the Committee on Ways and Means, United States House of Representatives, to more fully elaborate on the discussions that were presented to the Committee and the recommendations of the Committee which appear more fully on page 30. I ask that the attached pages be considered as a part of my statement and be included in the Committee record.

Mr. Chairman, if we continue to allow the states to proliferate the use of the worldwide combined reporting system as a method of determining state corporate taxation assessments, we will subject foreign corporations, wishing to make an investment of capital and employment opportunities, to 51 separate tax policies on foreign source income. Certainly the issue is national in scope and thus requires federal legislative action such as proposed in S. 1688. Thank you, Mr. Chairman.

IV. STATE TAXATION OF FOREIGN SOURCE INCOME

Present law and background

General structure of State taxation of corporations.—The question of State taxation of foreign source income is one aspect of the larger question of State taxation of businesses operating in more than one State. This larger question involves the problem of determining a State's jurisdiction for taxing a corporation's income and uniform rules for apportioning and allocating that income among the States in which a corporation does business. Of the 45 States which impose a corporate income tax, all use some kind of formula to apportion business income between the various States in which a corporation operates. However, the specific formula used varies substantially from State to State.

In determining income earned within a State, most States (30 out of 45) use some variation of a basic three-factor apportionment formula. Under this formula the income of a corporation is apportioned to each State according to the average ratio of three factors: the sales, payroll, and property values in the State to total sales, payroll, property values of the corporation. For example, a corporation which has one-half of the value of its property, three-fourths of its payroll, and one-fourth of its sales in a particular State would take the average of these three fractions (or one-half) to determine the amount of income subject to tax in that State.[1]

A State's apportionment formula is usually applied only to income of a corporation where the business activity from within the State is dependent upon, or contributes to, business activities of the same corporation outside of the State. Ordinarily, in a case where the business activity in the State is unrelated to other businesses of the corporation outside of the State, all of the income from that business within that State is allocated to that State (and the income from the other businesses is not allocated to the State).

Some States, primarily California and Oregon, have adopted what is known as the "unitary method" of applying the three-factor apportionment formula. Under this method the formula is applied not only to the income of the specific corporation operating in the State, but also to any income of related corporations (subsidiaries, parent corporations, or brother-sister corporations) where the related corporations' activities outside of the State are dependent upon or contribute to the business of the corporation within the taxing State.

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[1] The 15 States which do not follow this three-factor formula use other apportionment formulas, some based on property values only and others based on a combination of sales and property or sales and payroll or property and payroll. Even among those States which do use the basic three-factor formula, the manner of measuring the three items in the formula may differ. For example, in some States a sale is taken into account by the State where the sale originated (generally, the location of the seller) while in other States the sale is allocated to the State of destination (generally where the buyer is located).

In many States, not all of the income of a corporation is subject to that State's apportionment formula. For example, in many States passive income such as dividend income is allocated entirely to the State of the "commercial domicile" (or in some cases the State of the "principal business location") of the corporation and is thus excluded from the income subject to the apportionment formula.

Taxation by States of foreign source income.—Virtually all States include the income of foreign branches of domestic corporations in the income which is subject to their apportionment formula. For example, if a corporation had two-thirds of its sales abroad, but the other one-third of its sales, one-half of its property, and two-thirds of its payroll in one State, the corporation would be taxed on one-half of its income by that State.

In those States which have adopted the unitary method and thus apply their apportionment formula to income of a related group of corporations, the income of foreign affiliates of U.S. corporations is subject to apportionment if the activities of the foreign affiliates are dependent upon or contribute to the business of the corporation within the taxing State. These States thus treat income of foreign corporations related to U.S. corporations in the same manner as most States treat income of foreign branches of U.S. corporations.

Dividends of a foreign subsidiary are sometimes subject to State tax when received by a domestic corporation. In these cases the dividends are taxed in the same manner as dividends from domestic corporations (i.e., taxed by the State where the corporation is commercially domiciled or has its principal place of business, added to the income subject to the apportionment formula of the taxing State, or, in some cases, taxed in both States). However, many States do not significantly tax any dividends from related corporations.

Previous attempts to modify present law.—As a result of court decisions in the late 1950s and early 1960s which expanded the constitutional limits of a State's jurisdiction to tax corporations with minimal levels of economic activity within the boundaries of that State, Federal legislation was enacted which required that a corporation at least accept and approve sales orders within any State before that corporation can be subjected to the income tax of that State. In more recent years, legislation mandating greater uniformity in the rules for State taxation of corporations has been introduced and studied. One such bill, which was reported by the House Judiciary Committee, passed the House in 1969 but was not enacted.

In 1966, a group of States reacted to the possibility of Federal legislation by adopting a multi-state tax compact, which established the Multistate Tax Commission whose duties are to establish uniform income tax regulations, auditing standards and tax forms for member States. Presently, 20 States are members of the compact (the majority of the States are Midwestern and Western States). Under the compact, the regulations of the Multistate Commission are effective in all member States, but any member State can adopt overriding regulations if they choose. Since most of these States have adopted some overriding regulations, the methods of taxing corporations still vary substantially among States which are members of the compact.

Issues

Although a larger controversy exists over the States' jurisdiction to tax income and the need for uniform rules among the States, the basic issue before the task force was whether the Federal Government should prohibit States (a) from taxing foreign source income directly, or (b) from taking into account foreign source income under the unitary method (as described above).

Alternatives

Limitations in applying the unitary method of apportionment.—States could be prohibited from requiring the reporting of income and related items of foreign corporations even though related to U.S. corporations which operate within that State. Under this proposal, the unitary method would not be applied either to foreign subsidiaries of U.S. corporations, to foreign parents of U.S. subsidiaries, or to other affiliated foreign corporations. This would not, however, prevent a State from taxing dividends paid by foreign subsidiaries, interest, or royalties received from foreign affiliates or other foreign sources, nor would it prevent the application of the three-factor formula to branch income from foreign operations of U.S. corporations operating in the State.

The reporting of income and related items of foreign corporations could be limited to activities of U.S. corporations which relate to exports from or imports to the United States, but the treatment of dividends, etc., could remain the same as above for income from other corporations.

The reporting of income and related items could be barred in the case of foreign-owned corporations with affiliates operating in any State, but allowed with respect to foreign subsidiaries of U.S.-owned corporations operating within the State (as would be done with U.K.-owned companies in the proposed convention between the United States and the United Kingdom). Dividends, etc., could remain taxable as above. Under this proposal, in the case of foreign-owned affiliated groups of corporations, any State would be limited to applying its apportionment formula to the income of any member of the affiliated group operating within that State or other States.

Limitations on direct taxation of foreign source income.—States could be prohibited from directly taxing in any way foreign source income. This means they not only would not tax income through the unitary method, but also would not tax dividends from foreign subsidiaries, foreign source interest or royalties, or branch earnings of U.S. corporations. The States could also be prohibited from taxing foreign income of individuals.

States could be prohibited from taxing through the unitary method foreign affiliates not doing business in the State or from taxing dividends from foreign affiliates of U.S. companies, but allowed to tax interest or royalties or branch income.

Analysis

Limitations on the unitary method of apportionment.—For Federal income tax purposes, an apportionment formula is not used to divide income and costs between United States and foreign countries. Instead, income and costs are allocated between related companies using the criterion of what the costs and prices would be between these parties if they were independent parties dealing at arm's length (sec. 482). On the other hand, in computing what portion of the income of a single company is from foreign sources, an allocation of income and deductions approach is used (sec. 861). This approach already produces significant problems when applied at the Federal level and would be virtually impossible to administer at the State level as applied to interstate transactions. Thus, there is no significant disagreement that the States must use some type of apportionment formula (as distinguished from making an allocation of income and deductions by separate accounting), since there would be no practical way of determining what income of a company is earned within a State as opposed to being earned within other States (or in foreign countries).

The rationale presented for using the unitary method to combine the business activities of related corporations which contribute to the business activities of a corporation within a taxing State is that the operations form an integrated business, and whether the business is conducted through a number of separate corporations or through one single corporation should not affect tax liability.

It is disputed whether those States applying the unitary method of taxing corporate business income under an apportionment formula do, in fact, tax the income of related foreign corporations. For example, under the three-factor apportionment formula, if it takes the same dollar amount of sales, the same value of property and the same sized payroll to achieve a given level of income in the foreign subsidiary as it takes in U.S. operations, then no foreign income would be taxed by any State because the three factors would apportion the appropriate amount of income to foreign countries and to the State.

However, it is argued that in many countries abroad wages and property values are lower in proportion to income than in the United States. It is argued that, given these circumstances, the inclusion of foreign corporations under the unitary method of apportionment leads indirectly to State taxation of foreign source income by apportioning too much income to the United States. Whether or not this actually is the result in any specific case depends on whether the proportion of income to wages, property costs and sales in the specific country in which a corporation operates is higher than the proportion of the same items in the United States. In some cases, the unitary method operates to apportion more income to the United States than most people would agree should be so apportioned if each affiliate were treated as an independent entity operating on an arm's-length basis. However, in other cases the application of the unitary method may apportion less income to a State than would be apportioned under other acceptable methods.

An additional problem raised in relation to those States which have adopted the unitary method is the administrative burden which that method places on corporate taxpayers, particularly those which are foreign owned. For example, a corporation with one manufacturing plant in a unitary State has to obtain for that State's tax purposes the income, sales, property and payroll figures of all of its affiliates operating worldwide if the activities of those affiliates are dependent upon or contribute to the activities of the corporation within that State. In the case of a foreign parent corporation, this compliance burden could be particularly costly because a foreign-owned foreign corporation ordinarily would not otherwise keep the books of its operations outside of the United States in terms of U.S. dollars or in a manner which would conform to U.S. accounting concepts.

The need for applying the unitary method may not be as great when taking into account foreign source income than when taking into account income from a number of States. The number of transactions in any State linked to foreign operations is ordinarily substantially fewer than the number of transactions linked to different States. Moreover, since taxpayers are in any event required to allocate income between U.S. and foreign sources for Federal income tax purposes, the States could adopt the Federal rules for apportioning income from foreign transactions between domestic and foreign sources.

Some critics of the unitary method of apportionment would nevertheless permit its use where the States can show that there is less than arm's length pricing in foreign transactions. If the unitary method were allowed only in this case, the State affected to the most substantial extent would be California. California State tax officials estimate that such a limitation would cost that State approximately $125 million in revenue, or about 12 percent of total corporate tax revenues.

It has also been suggested that the application of the unitary method could be limited to those cases where the business activities of the foreign subsidiaries are related to exports from or imports into the United States. Export-related transactions generate the most difficult income allocation questions under the Federal tax rules, and thus it is suggested that it is appropriate to allow the States to decide whether Federal rules should be followed in those circumstances.

If the administrative burden which the unitary method causes taxpayers is viewed as the primary problem, the application of the unitary method to foreign corporations owned by foreigners could be prohibited.

Limitations on directly taxing dividends from foreign subsidiaries.—

Except as that result may be achieved indirectly under the unitary system, no State taxes the income of foreign subsidiaries (not doing business with the State) of U.S. corporations as that income is earned; that income is taxed only when it is remitted to a U.S. corporation as a dividend. In those States which tax foreign source dividends, it is argued that double taxation results because no credit is allowed for foreign taxes paid.

The Federal Government taxes dividends from foreign subsidiaries of U.S. corporations when they are brought back to the United States, but allows a foreign tax credit for foreign (national, state and local) income taxes paid by the subsidiary. Thus, to the extent that foreign income taxes do not exceed 48 percent of foreign taxable income, the tax burden on foreign source income also taxed by a State is no greater than the tax burden on domestic source income which is taxed by the Federal Government at 48 percent and by the State as well.

As in the case of State taxation of dividends from domestic corporations, the lack of uniform rules among the States does lead to over-taxation or under-taxation in various cases. If the taxation of dividends of foreign subsidiaries is prohibited, domestic source income in some cases will be taxed more heavily than foreign source income because all income taxes paid to local governments in foreign countries, as well as the income taxes paid their national governments, are creditable against U.S. Federal tax while income taxes paid to U.S., State and local governments are only deductible, and not creditable for Federal purposes.

Recommendations

The task force makes the following recommendations with respect to State taxation of foreign source income:

(1) *Income of foreign affiliates not subject to Federal income tax.*—It is recommended that the States be precluded from taking into account, under the unitary method or any other method, the income of foreign affiliates of corporations doing business within the States until such time as that income is subject to Federal income tax.

(2) *Income of foreign affiliates subject to Federal income tax.*—It is further recommended that no limitation be placed on the power of the States to apply the three-factor formula on a domestic basis, under the unitary method or otherwise, to income of foreign affiliates which had been excluded under paragraph (1) above if and when such income becomes subject to Federal income tax.

STATEMENT OF THE TAX COUNCIL
ON S. 1688 and S. 983
SUBMITTED TO THE COMMITTEE ON FINANCE
U.S. SENATE

JUNE 24, 1980

The Tax Council is a nonprofit business membership organization concerned with a wide range of tax policy issues. Since its inception in 1967, The Council has emphasized the benefits accruing to all sectors of our economy from increases in our nation's stock of capital. The Council has consistently advocated a tax structure that would encourage capital accumulation and preservation.

The taxation of business income by different levels of government is of great concern to our economic health and particularly to the members of The Tax Council. The problems that give rise to S. 1688 and S. 983 have many philosophic, political, and administrative dimensions, and have been reviewed extensively by state and Federal Courts and by Congressional Committees for over 20 years. Stated simply, the principal question facing us is: To what extent should a state or political subdivision tax the income of a business that has operations both within and without that subdivision?

The fundamental issue in the state taxation of business income is the appropriate determination of the amount of such income earned within each state. It is uniformly agreed that each state has the right to tax profits from business operations conducted within that state. Where operations are conducted solely within a state, the determination of profits is relatively simple. Where operations are conducted in more than one state, however, complications arise from transactions among divisions of the business entity that cross state boundaries.

The Unitary Apportionment Method

A number of states have adopted a three-factor formula to determine the portion of business income that should be subject to a particular state's tax. This formula, comprised of the ratios of statewide and total sales, payroll, and property, has been fairly well developed and accepted, with court decisions clarifying some gray areas. The courts, however, have been unable to work out what income should be subject to the apportionment formula and under what conditions. Some states have adopted a "unitary" method of determining a corporation's income which suggests that if the operation of the business done within the state is dependent on or contributes to the operation of the business without the state, the operations are unitary.

This approach to the calculation of income subject to tax in a particular state starts from the arbitrary assumption that these three factors will result in a reasonable determination of profits earned in a state. If operations are conducted solely within the United States, where economic and business conditions are relatively consistent, a reasonable result may be reached. S. 983 goes a long way toward establishing a fair statutory approach to the multistate taxation on interstate operations; however, when the unitary concept in applied to worldwide operations where there are major differences in laws, property values, wage rates, currency exchange and control problems, major inaccuracies and inequities can result. The effect on worldwide operations of S. 1688, and this is the issue which should be dealt with first.

Application of the unitary approach to worldwide operations can vastly oversimplify an overall business structure and permits a state to include in its tax formula the sales, payroll, and property factors of a foreign business that is controlled by an otherwise unrelated domestic company operating in a particular state. The factoring in of the foreign business is done even if all transactions between the companies are conducted on an arms length basis. The profitability of the domestic entity may be quite different from that of the foreign associate but the unitary factors may result in the attribution to a particular state of income completely unrelated to operations within that state. Not only can multiple taxation of profts result but, in some cases, tax would be imposed on amounts that are not real profits in any sense of the word.

Why Is Federal Legislation Needed?

The case that has developed on state taxation of worldwide profits contains an important and pertinent theme--that the courts, including the Supreme Court of the United States, look to Congress to lead in the reconciliation of the legitimate concern about state tax revenues and the fair treatment of multinational business entities.

The drafting of S. 1688 comes after many years of unsuccessful efforts to enact comprehensive legislative reform in the multistate tax area. This proposal carves out a manageable beginning, the tax treatment of foreign source income, that can be a useful building block in the resolution of other important issues in state taxation such as are addressed in S. 983.

The bill recognizes the principle that state and local governments have the authority to tax business profits that are generated abroad, but the timing in recognition of such profits would be limited to the same rules which apply at the Federal level as set forth in the Internal Revenue Code. These rules are drafted to insure that all income to a U.S. corporation is subject to valid taxation (1) by the foreign country in which the income is generated, (2) by the Federal government when that income is repatriated, and (3) by the state and local authority when that income is attributable to operations within the taxing entity.

The essential features of S. 1688 are consistent with the recommendations of the Task Force on Foreign Source Income of the Ways and Means Committee, issued in March 1977. After carefully considering the background of the issues involved in the state taxation of foreign source income, the Task Force recommended restrictions on the use of the unitary method prior to the time that foreign income is subject to Federal income taxes.

The logic and value of this approach are that it minimizes the potential for unfair and multiple taxation of income. In addition, S. 1688 would have two other desirable aspects.

First, the lack of direction that caused expensive delays and frustrations in negotiating and ratifying the U.S.-U.K. Tax Treaty is a serious obstacle in negotiating many other such treaties. S. 1688 would be extremely beneficial in creating consistency in international tax treatment. It should also be a significant factor in deterring other governments from adopting similar provisions applicable to U.S. corporations doing business in their countries in retaliation for the unfair treatment by jurisdictions within the United States.

Second, uncertainty about the appropriate approach has generated expensive litigation, some of which undoubtedly cost both sides more than the resulting settlement, but which only resolved part of the controversy by settling on definitions, and not procedures.

S. 1688 offers a sound offers a sound approach to attempting to resolve significant policy issues in the state taxation of business income. It is a very desirable first step. The Tax Council appreciates the to present its views on this legislation and strongly recommends its adoption.

STATEMENT OF
THE INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA
RELATING TO S.983
"Interstate Taxation Act of 1979"

The Interstate Natural Gas Association of America (INGAA) is pleased to express its views on this important piece of legislation. INGAA is a nonprofit trade association representing virtually all of the interstate natural gas transmission companies. Some of our member companies, through affiliates, have diversified operations in activities such as oil and gas exploration, development, production, refining, marketing, etc. Therefore, the system of taxation of interstate commerce is of vital interest to our member companies.

INGAA has followed the progress of various bills introduced in Congress over the years and has worked with other organizations to try to find the answers to problems confronting companies which have various activities in several states. Through the years, each state wishing to maximize its tax revenues has explored various avenues of taxation which has often encroached upon the traditional right to tax profits claimed by another state. While this was often done under the guise that such profits were more appropriately related to one state than another, or such profits more appropriately should be apportioned among the states, often the result was the same profits were being taxed by different states and by different methods.

In this current bill, INGAA recognizes the merits of a fair system which allows each state to tax its fair share of profits of a company. At the same time we recognize that various states have different ways of taxing these profits. For instance, some state taxing authorities tax pipeline companies using a so called "revenue-miles" formula instead of a three-factor formula. This method has proved to be the most equitable and staisfactory for both the states involved and the gas companies. Upon enactment of this bill, states may wish to change their overall method of taxation of all the interstate companies doing business in their jurisdiction, including gas companies.

We propose an amendment (see attached Exhibit A) to the bill designed to assure corporations engaged in the business of transporting gas in interstate commerce the protection of this bill in the event the state taxing authority determines to change its present method of such taxation.

In this event, should such change be significant, then the gas companies would be afforded the protection of the three-factor formula of this bill, but only if the net revenue impact of such change were to exceed the revenue produced by the three-factor formula.

This would assure the various states of continued flexibility in their taxing policy and at the same time provide the full protection of this bill to gas companies.

With these comments, INGAA is in full support of S.983.

EXHIBIT A

AMENDMENT TO S. 983

Section 301 of the Bill, relating to optional three-factor formula, is amended by redesignating Section 301 as 301(a) and by adding a new subsection (b) at the end of such redesignated Section 301(a), such new subsection (b) to read as follows:

"(b)(1) The provisions of subsection (a) shall not apply to any corporation more than 50 percent of the ordinary gross income of which for the taxable year is derived from regularly carrying on the business of transportation of gas.

(2) Paragraph (1) shall not apply, and the provisions of subsection (a) shall apply, to any such corporation if and to the extent that a State or political subdivision changes its method of apportioning or allocating net income of the corporation to such State or political subdivision. For purposes of this paragraph, a State or political subdivision shall be deemed to have changed its method of apportioning or allocating the income of such a corporation if it shall change the basis upon which the level of activity or presence of such corporation in such State or political subdivision is measured, by any addition, deletion or change in the relative weight or importance of one or more factors taken into the income apportionment formula applicable to such corporation, excluding, however, a mere change in the numerator or denominator of any such factor to reflect changed facts or circumstances if such change is made on a basis consistent with prior years.".

INDUSTRIES

PPG INDUSTRIES, INC./ONE GATEWAY CENTER/PITTSBURGH, PENNSYLVANIA 15222/AREA 412/434-2476

EDWARD I. SPROULL, JR.
Vice President, Tax Administration

June 27, 1980

The Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on Taxation
 and Debt Management
Finance Committee
United States Senate
2227 Dirksen Senate Office Building
Washington, D.C. 20515

Dear Senator Byrd:

PPG Industries, Inc. (PPG) appreciates the opportunity to submit this statement for insertion in the record of hearings on Senate Bills S.983 and S.1688.

PPG strongly supports the passage of S.1688. The enactment of this bill would conform state taxation of income received by domestic parents from foreign affiliates to the federal rules. The limitations contained in the bill would permit the states to tax foreign source corporation income on a fair and equitable basis. Only the timing and the quantity of the income to be taxed by the states would be affected.

The federal allowance of foreign tax credits reduces the problem of double taxation. S.1688 further reduces double taxation by conforming state and federal rules related to timing.

While the bill eliminates state double taxation, it does provide a mechanism for all states to tax that part of foreign source dividends which are not subject to taxation at U.S. federal tax rates in the foreign country. The bill also cures the problem of double taxation by those states which tax that portion of foreign source dividends generally referred to as "gross-up." The concept of taxation of "gross-up" by certain states is a clear example of double taxation since it is a "tax upon tax."

In summary, we support S.1688 because it will eliminate double taxation by the states of foreign source dividends and permit the state to tax such income on an equitable basis.

Sincerely,

EISproull Jr

Edward I. Sproull, Jr.

EIS:pm

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Alan M. Breitman
Assistant Treasurer
Director of Taxes

July 2, 1980

The Honorable Harry F. Byrd, Jr.
Chairman
Subcommittee on Taxation
and Debt Management
Committee on Finance
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

In accordance with the requirements of Press Release #H-31, dated June 6, 1980, this statement is submitted for the printed record of hearings before the Subcommittee on Taxation and Debt Management, regarding S. 1688, a bill introduced by Senator Mathias, which would limit application of the so-called "unitary business" concept and bring state tax policies into line with Federal tax policy.

American Cyanamid Company is a multinational corporation with headquarters in Wayne, New Jersey. Cyanamid and its subsidiaries are engaged primarily in the manufacture and sale of a highly diversified line of agricultural, consumer, medical, specialty chemical and Formica brand products in more than 135 countries throughout the world. Cyanamid has facilities of different types and varying sizes in 30 states of the United States.

Generally, Federal tax law recognizes the separate legal existence of distinct legal entities and applies the provisions of the

Internal Revenue Code to each such separate entity. Taxpayers may elect to depart from the general standard in certain instances (i.e., consolidated returns, Subchapter S corporations), and several exceptions have been enacted to cover areas of potential abuse (i.e., Section 482, Subpart F, etc.).

Contrariwise, the unitary business concept, perfected in its application by the State of California, ignores the concept of separate legal entities, and subjects to tax the worldwide income of an affiliated group of U. S. and foreign corporations, based upon the theory that there is some mutual dependency within the group that inures to the benefit of each member of the group. It doesn't matter, under the unitary concept, that a United Kingdom, German or French subsidiary conducts no business and earns no income within the State of California, that there would not be sufficient nexus for California to tax that subsidiary directly, or even that there are no transactions between the domestic parent's business in California and the foreign subsidiary's business. It doesn't even matter that, under the Internal Revenue Code, the income of the foreign subsidiary is not subject to U. S. tax. California states that it is not taxing the foreign subsidiary - it is taxing the parent based upon the income of the foreign subsidiary. That, I suggest, is a distinction without a difference.

The State of California has required American Cyanamid Company to report its worldwide income on a unitary basis. At the end of 1979, six companies of the Cyanamid group were qualified to do business in California - American Cyanamid Company, Formica Corporation, J. H. Breck, Inc., Glendale Optical Company, Inc., Shulton, Inc., and Cyanamid Plastics, Inc. Cyanamid's 10-K Report lists 68 subsidiary companies, most organized under the laws of, and primarily in, foreign countries and with no operations or presence in California.

Inherent in the unitary concept formula is the erroneous assumption that the various factors which affect the allocation of income, such as payroll costs, cost of sales, sales prices and property costs are uniform throughout the world. This erroneous assumption causes a serious distortion of allocable income which, coincidentally, usually results in an overallocation to the state which applies the unitary concept. Thus, in California for 1978, the most recent year for which we have completed returns, the results were:

ACTUAL CALIFORNIA TAX PAID, Applying the Worldwide unitary Concept	$612,000
CALIFORNIA STATE TAX, if the Unitary Concept Had Been Applied to U. S. Operations Only	$367,000
EXCESS CALIFORNIA TAX PAID, Due to State Taxation of Foreign-Source Subsidiary Income	$245,000

Although the initial excess cost to Cyanamid approximates $250,000, forty-six percent (46%) of that cost, or about $115,000, is borne by the

United States Treasury, since state taxes are deductible for purposes of the Federal income tax. Thus, the unitary concept not only punishes the multinational corporation, it siphons funds from the Federal government. If all states in which Cyanamid does business utilized the unitary business concept, our additional cost would be $7.1 million, if imposed on a worldwide basis, and about $2.6 million, if only U. S. subsidiaries were included. Again, the Federal government would be burdened with 46% of that additional cost.

There is no equitable rationale for application of the unitary business concept to foreign subsidiary companies. The Section 482 arm's length standard for transactions between related parties, as strictly and conscientiously enforced by the Internal Revenue Service, provides adequate protection against shifting of income and other potential abuses. All major corporations are audited annually by the IRS, and all corporations subject to the California franchise tax are required to report IRS changes to the State. Thus, the State is fully protected in this respect, without even using its own audit staff.

The extraterritorial extension of state tax jurisdiction to international operations has resulted in unfair and inequitable taxation, double taxation of the same income, and taxation before income actually is received or accrued, all of which are counter to Federal taxation principles.

Perhaps most important from a public policy viewpoint, application of the unitary concept by the states interferes with the setting of international trade policies by the Federal government by claiming extraterritorial tax jurisdiction on income earned outside the United States. Because the unitary concept could spread to additional states, and because it may be emulated by governments of developing nations, legislation is needed now to assert Federal preeminence and authority in this area.

S. 1688 does not eliminate all the inequities in the unitary concept. It would merely limit taxability to earnings of subsidiaries which are subject to the Federal income tax, thereby excluding the income of most subsidiaries. Cyanamid believes that the unitary concept is improper under any conditions when applied to subsidiaries, including U. S. subsidiaries, which have no nexus with the taxing state. Nonetheless, we support S. 1688 as a major step in eliminating a significant injustice.

Respectfully,

Alan M. Breitman

AMB:ejc

Alan M. Breitman
Director of Taxes

ELI LILLY AND COMPANY

INTRODUCTION

Eli Lilly and Company believes that Federal legislation is essential now if there is to be an acceptable system for the taxation of interstate and foreign commerce by States and local governments. Uniform Federal legislation could provide a simple, equitable, and sufficient tax on business while avoiding the complexity, uncertainty, and multiple taxation that characterize the existing pattern of State and local taxation.

THE PROBLEM CANNOT BE SOLVED IN THE COURTS

Recourse to the courts is not the answer to these pervasive problems. More than 300 cases, which resulted in a body of law notable primarily for its complexity, were decided by the U.S. Supreme Court before Congress exercised its authority in 1959 and provided Public Law 86-272. In recent years the Court has refused to hear important state tax cases (e.g. Chase Brass and Copper Co., Inc. v. Franchise Tax Board; Johns-Manville Products Corporation v. Commissioner). Further, even when the Court has reviewed cases, its decisions have done little to bring order to the chaos created by the multiplicity of conflicting state tax requirements. Its decision in Moorman Manufacturing Co. v. Bair upholding Iowa's single-factor (sales) apportionment formula set back immeasurably the longterm combined efforts of State tax administrators, business taxpayers, and academicians to evolve a reasonable multifactor formula.

In Japan Lines, Ltd. v. County of Los Angeles the Supreme Court added two further requirements to the tests applicable to State taxation of interstate commerce: (1) the tax must not pose a substantial risk of international multiple taxation, and (2) it must not prevent the Federal Government from speaking with one voice when regulating commercial relations with foreign governments. The Court concluded that a state tax which contravenes either of these precepts is unconstitutional under the Commerce Clause. This decision is an implicit threat to the constitutionality of mandated worldwide combined reporting. It inevitably will result in the proliferation of taxpayer litigation.

The inability of the Supreme Court to resolve the difficult interstate and foreign tax issues, and the inappropriateness of its trying to do so, is acknowledged by the Court itself.

> It is clear that the legislative power granted Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all states to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions. [Moorman Manufacturing Company v. Bair, 437 U.S. 267, 98 S.Ct. 2340 (1978)].

Further, in its very recent decision in Mobil Oil v. Vermont [___ U.S. ___ (1980), 48 USLW 4306 (3/18/80)] the Court reiterates that any uniform solution to interstate tax problems must come from Congress.

ELI LILLY AND COMPANY
Statement on S. 983 and S. 1688
June 24, 1980

INTERNATIONAL ASPECTS

A further complexity has been introduced in the form of novel concepts of taxation which deviate from established patterns. In particular, the spread of worldwide combined reporting (unitary) procedures and the growing trend toward apportionment of dividends and other income from intangibles, rather than their allocation to the state of commercial domicile, have tremendous impact on the complexity of complying with state tax requirements and on the exposure to multiple taxation of income.

Not only has the extension of combined reporting procedures to subsidiaries of domestic companies caused many difficulties, but the practice also has created serious international problems in its application to foreign corporations with subsidiaries in the United States. The unitary reporting system runs counter to the general international principle that profits should be allocated among the various companies of a group on an arm's-length basis, e.g. the OECD model of double taxation, and the United Kingdom, Japan, Canada and other countries have raised strong objections to the use of combined reporting methods of tax determination by some States. The ratification of the United Kingdom-United States tax treaty by the British Parliament was long delayed because the clause prohibiting States from requiring worldwide combined reporting was striken from the treaty. British concerns with this method of tax determination were eloquently expressed in the Parliamentary debates on the treaty wherein unitary reporting was called "a rather arbitrary and capricious measure of profits", "international robbery", "extremely complicated, imposes a lot of extra work on companies, and is patently unfair", and "dangerous and shortsighted". In approving the treaty Parliment relied "on our friends in America . . . to complete their legislation and abolish this grossly unfair tax". [House of Commons Official Report, Parliamentary Debates, Vol. 979, No. 120 (19 Feb. 1980)].

If international investment is driven from those States which have adopted world wide combined reporting procedures and other countries are moved to retaliate in kind against United States investments abroad, both the States and United States businesses will suffer in the long run. Therefore, Eli Lilly and Company believes it is in the interest of both business and the States to conform State tax procedures to internationally acceptable methods.

S. 983

The adoption of Federal legislation such as S. 983 would be a major step toward solving the problems outlined above and bringing badly needed uniformity to the taxation of interstate and foreign commerce. This bill sets out uniform jurisdictional standards for imposing sales, use, and gross receipts taxes.

In addition, S. 983 prevents a State from imposing its tax on more income than would be apportioned to that State under an apportionment formula consisting of equally weighted sales, property, and payroll factors. This provision would eliminate the threat, and in many cases the reality, of double taxation which is inherent in the current use of a variety of apportionment formulae by the States.

Dividends from corporations which are more than 50% owned by the taxpaying corporation and foreign source income are not apportionable or allocable to any State. This provision reaffirms the basic principles that each State is entitled to tax that portion of a corporation's income, and only that portion, which the State's economy generated, and that each corporation's income should be taxed only once.

This treatment does not produce a preferential lower tax on foreign source income and does not create a tax preference for foreign investment. This legislation merely removes the present discriminatory bias against foreign investment created by State tax policies. In general, States tax foreign source dividends more heavily than domestic source dividends, despite the fact that States properly should not tax foreign source dividends at all. This occurs because States typically start with the Federal income base which includes only minor portions of domestic dividends, but includes all foreign dividends. The States then do not give recognition to the foreign taxes which have been paid on the foreign dividends.

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S. 1688

S. 1688 is more limited in scope than S. 983 and addresses only some of the problems outlined above. This bill precludes the application of a worldwide combination formula to a foreign subsidiary or a foreign parent. This treatment is appropriate since, where income is from foreign sources and all of the corporation's property, payroll and sales factors are located outside the United States, no State's economy has generated the business profits of that corporation.

S. 1688 does, however, allow a State to tax foreign source income at such time as that income is taxed by the Federal government. Thus, such income would not be taxed by the States until a dividend was paid or deemed paid.

In addition, the amount of such foreign source income which could be taxed by the States is limited to that portion of the dividend that the Federal government effectively taxes. In other words States would have to take into account foreign tax credits in applying State taxes to foreign source income.

Bringing uniformity and certainty to these important areas of interstate and foreign taxation certainly is beneficial. It would be even more beneficial, however, if Congress would respond to the charge placed upon it by the Supreme Court in Moorman and Mobil Oil and also resolve the issues relating to division of income by mandating a uniform apportionment formula and a uniform treatment of income from intangibles.

CONCLUSION

The courts and the individual States have been unable to resolve the complex issues of taxation of interstate and foreign commerce. Indeed, far from any trend toward uniformity which would mitigate the need for federal legislation, the emergence of novel concepts of taxation which are at variance with long established practice has served only to exacerbate the problems. Therefore, it is clear that the time has come for Federal legislation which will create mandated order and uniformity in the areas of interstate and foreign taxation. S. 1688 does not address all of the issues in these areas. It does, however, solve the pervasive problems arising from worldwide combined reporting procedures. S. 983 addresses more of the issues since it also places a ceiling on the amount of income from interstate businesses which a state can tax measured by a uniform apportionment formula. For these reasons, Eli Lilly and Company strongly urges the support of Congress for these bills and respectfully requests the Committee to act favorably and expeditiously on this legislation.

STATEMENT OF
THE AMERICAN TEXTILE MANUFACTURERS INSTITUTE, INC.
ON S. 983 AND S. 1688

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The American Textile Manufacturers Institute, Inc. strongly supports the sales and use tax and gross receipts tax proposals contained in S. 983 and the limitations placed on state taxation of foreign source income by S. 1688. If enacted, these bills will both simplify tax administration and significantly reduce the risk of multiple interstate and international taxation.

Following is a more detailed section-by-section analysis of both bills.

S. 1688

The amendments to the Internal Revenue Code proposed by this bill will substantially stop the worldwide unitary tax system at the water's edge by prohibiting any state from including foreign source income in its tax base to a greater extent

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than the Federal Government does. The enactment of S. 1688 is vitally important in light of the Supreme Court's recent decisions in Mobil Oil Corporation v. Commissioner of Taxes of Vermont, No. 78-1201 (March 19, 1980) and Exxon Corporation v. Wisconsin Department of Revenue, No. 79-509 (June 10, 1980), which confirm that the states have broad constitutional authority to tax a resident corporation's foreign source income.

Proposed section 7518(a) of the Internal Revenue Code prohibits any state from including the income of a foreign affiliated corporation in its apportionment formula unless it is includible in the corporation's Federal gross income under Subpart F. Because ATMI believes that the worldwide unitary method of taxation is fundamentally unfair in that the wide disparities in the primary economic factors around the world generally cause a disproportionate amount of income to be allocated to the domestic taxing state, it supports any measure that will significantly reduce the magnitude of this distortion by limiting the foreign source income subject to apportionment.

Proposed section 7518(e) of the Code requires states that include foreign source dividends in their tax base to give account to foreign taxes paid with respect to such dividends, and it will prohibit them from taxing these dividends to a greater extent than the Federal Government. If this measure is not enacted, legislative action at the Federal level will

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be needed to require states which include foreign source dividends in their tax base to also include an appropriate portion of the foreign property, payroll and sales of the foreign corporation paying such dividend in their apportionment formula fractions.

S. 983

This bill will provide much needed relief to multistate taxpayers by creating uniform standards with respect to sales and use taxes, gross receipts taxes, and net income taxes. Such national guidelines are necessary to protect multistate corporations or corporations engaged in interstate commerce from the the risk of being taxed twice on the same income.

Title I - Sales and Use Taxes

Title I establishes much needed guidelines to determine when a foreign seller of property is required to collect a sales or use tax with respect to such property.

Sections 101 and 105 provide that jurisdiction would be accorded in the presence of regular solicitation (section 101(a)(2)) or regular deliveries (section 101(a)(3); section 105) in the state. However, ATMI feels that it would be desirable for the bill to define what would constitute "regularity" in these respects in order to avoid having to develop a definition through the process of litigation. Furthermore, the meaning of solicitation under S. 983 remains as ambiguous as it currently exists under P.L. 86-272.

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The exclusion of freight charges incident to interstate sales from the imposition of a state sales or use tax in section 101(c) is good.

Section 102(d) and (e) will protect a taxpayer from double taxation with respect to sales of the same property by providing a credit for prior taxes paid to another state and a refund from a state in the event a taxpayer ascertains it has a prior liablity to another state. Both of these provisions are necessary to reduce the risk of multiple interstate taxation. However, it appears that section 106(a)(2) would still allow a state to impose a use tax with respect to property acquired outside that state and brought into that state by the purchaser, notwithstanding the fact that the taxpayer has already paid a sales tax in the other state.

Sections 104 and 105 provide relief to certain out-of-state taxpayers from the present requirement in many states, such as Ohio and Louisiana, of determining sales tax rates for each locality and filing regular returns, even though there may be only a few sales each year. The standard form of the sales tax return provided under section 104(e) should greatly facilitate compliance for companies which make substantial sales to many states. However, ATMI feels there is an even more pressing need for a standard sales tax exemption certificate under section 103.

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Title II - Gross Receipts Taxes

This title contains a clear jurisdictional standard in section 201 which should successfully counteract the increasing practice by states of imposing a gross receipts tax based solely on solicitation within the state.

Title III - Net Income Taxes

Instead of establishing a uniform jurisdictional standard for income taxes under section 301, section 354 provides that, except as otherwise provided in sections 301 and 302, the individual states will retain the power to define what income is subject to apportionment. ATMI feels it would be better to establish a clear jurisdictional standard within S. 983 in order to assure that the apportionment formula contained in Title III is applied in the same manner by all states.

The establishment of an equally weighted three-factor formula in section 301 is a much needed change which will overcome the distortion created by certain states, such as New York, which currently over-weight one or more factors to inflate the taxable base. However, the last sentence of section 301, which prohibits a state from making "any offsetting adjustment for an otherwise allowable deduction which is unrelated" to excluded dividends or foreign source income is inadequate because it does not clearly establish how to determine what costs are "unrelated" to the excluded income. A positive statement that adjustments

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of deduction may be made only with respect to incremental, direct costs attributable to foreign source income would alleviate much of this uncertainty.

The definitions of the property and sales factors in sections 355 and 357 are well written. A particularly good feature is the omission of any throw-back rule in determining the sales factor under section 357(b)(1).

No Title - Other Taxes

No provision is made to limit the imposition of capital stock taxes as defined in section 503 of S. 1245 in 1973. The capital stock taxes imposed by some states, such as Alabama, North Carolina, Pennsylvania, and Texas, are already more than nominal, and they may be increased in the future.

No provision of the bill anticipates innovative taxes that escape traditional classification - such as Michigan's "single business tax", which replaced its former franchise and income taxes and is being imposed solely on the basis of solicitation.

Statement of William L. Strong
Executive Vice President
The Firestone Tire & Rubber Company
before the
United States Senate Committee on Finance

Introductory

Mr. Chairman and members of the Committee, I am William L. Strong, Executive Vice President of The Firestone Tire & Rubber Company (an Ohio corporation). Firestone is primarily known for the manufacture and sale of tires, but is also a significant producer of a variety of chemical, industrial rubber and metal products. Firestone operates domestically in all 50 states and the District of Columbia through a network of 14 tire and 32 other manufacturing facilities and over 1400 company owned retail outlets. Firestone holds a majority ownership in 47 foreign corporations located in 35 countries. These foreign subsidiaries operate within their respective countries of incorporation.

Statement

Your Committee is to be commended for conducting these hearings and we appreciate the opportunity to submit this statement in support of S. 1688. We are well aware of the complexities associated with the taxation of "foreign source income." Like other multi-national businesses, academicians, state tax administrators, lawmakers and the courts, Firestone has for many years struggled with the perplexing problem of how and to what extent individual states should be permitted to tax "foreign source income." The need for federal guidelines becomes more and more evident and the courts have suggested the issue is a matter for legislative concern. Twice the House has passed interstate tax bills; H.R. 2138 in 1968 and H.R. 7906 in 1969. These bills were broader than S. 1688, dealing not only with state income tax, but also sales/use, and gross receipts taxes. They were inevitably doomed to failure primarily because they generated substantial opposition from state tax administrators citing unnecessary federal intervention into areas of state taxing authority. Hopefully, S. 1688 will not be subjected to this type opposition since it approaches the problem from a much narrower viewpoint and clearly falls within the purview of the legislative power granted Congress by the Commerce Clause of the Constitution. No state tax official can make a valid case against limiting or conforming his state's tax policy regarding the taxation of foreign source income to that of the federal government particularly when that tax policy is linked closely to "foreign policy."

Your Committee will undoubtedly be subjected to substantial duplication and repetition of statements in the course of these deliberations. I shall wherever possible avoid such duplication by concentrating on only a few points of special concern to Firestone and hopefully of some value to your Committee.

A. Ohio excludes substantially all foreign source income from the tax base. Ohio's present franchise tax law levies a tax on the higher of three alternatives:

1) A minimum fee of $50
2) Five (5) mills on the apportioned value of shares valued on a traditional net worth basis, or
3) The apportioned value of the shares based on a traditional income tax concept. The first $25,000 taxable income is taxed at a rate of 4%. Taxable income in excess of $25,000 is taxed at a rate of 8%.

The income tax feature of these alternates was newly enacted in 1972 and Firestone, like many others, participated in the legislative deliberations preceding enactment. The exclusion of foreign source income from the tax base was openly discussed and debated, particularly the revenue impact and the ever increasing controversy and litigation evolving across the country.

I am not aware that any precise revenue estimates were ever made public, but the Ohio legislature in its wisdom decided the devisiveness between tax administrators and taxpayers created by this type issue more than offset the revenue benefits and the exclusion of foreign source income was written into the law. In retrospect, Ohio's legislature should be commended for avoiding all the controversy so prevalent in some of the other states.

S. 1688 would have little or no revenue impact in Ohio and therefore the current administration has adopted a neutral position relative to the Bill.

B. California Worldwide Unitary Concept

The California Franchise Tax Board, for the first time, applied the worldwide unitary combined reporting method to Firestone for the fiscal years ended October 31, 1960-63. A deficiency was assessed on August 20, 1971 covering these four years. Hearings on our protest to the Franchise Tax Board were unsuccessful because of the Board's insistence that Firestone concede it was unitary with each of its over 50% owned foreign subsidiaries as a condition precedent to any discussion of adjustments to the worldwide apportionment formula to accommodate what we believe to be distortions. Firestone paid the disputed tax and interest and on September 14, 1971 initiated a claim in the Superior Court of Los Angeles County, California for the refund of taxes erroneously paid.

After long and costly discovery proceedings, our case was argued in late 1978. In its decision the Los Angeles Superior Court found that Firestone was not unitary with its foreign manufacturing investments (except Canada). In finding our plantation unitary the court failed to recognize any adjustment to the 3-factor formula. Both parties have appealed the decision.

Our California case vividly demonstrates some of the inequities inherent in the California Worldwide Unitary system. Your Committee will undoubtedly be confronted with some of these issues when comparing to the Federal system of taxing foreign source income with which S. 1688 seeks to comport.

1) The most obvious shortcoming in the worldwide three-factor formula as employed by California results from their assumption that the rates of profit in the countries around the world are consistent with those in the United States. Because rates of profit within the Continental United States are reasonably consistent, little distortion results from a formula that fails to recognize the rate of profitability as a factor of apportionment.

Conversely, the wide disparity and generally higher rates of profit in foreign lands grossly distort the results obtained by applying the traditional three-factor formula in a worldwide environment.

2) To accurately apportion income the factors must fairly represent the income to be apportioned; they must be homogeneous among all of the jurisdictions in which the income is being apportioned. In recognition of this, most state statutes provide for the inclusion of a distortive factor, the inclusion of an additional factor

like cost of goods sold, or the substitution of a special apportionment method like separate accounting.

In our California case there was a wide disparity in wage rates in which, for example, the hourly rate in California is fifteen times or more the hourly rate in some other parts of the world. This wide disparity not only distorts the wage factor but also the property tax factor as wages and labor constitute a substantial component of the value of inventory and fixed assets. Thus, two of the three factors are substantially distorted as a result of wage differential.

The property factor is presumed to include all property utilized in the production of the income to be apportioned. Surprisingly, some property utilized in the production of income is neither owned nor rented and therefore by definition is not included in the property factor of the apportionment formula. An example would be government owned equipment. The same distortion results when an item is included but at an abnormal value either high or low. Our leased Liberian rubber plantation acreage is a good example. The California Supreme Court addressed the government owned equipment issue in the McDonnell Douglas case holding that an appropriate value representing the government owned equipment must be placed in the property tax factor in order to fairly apportion the income generated thereby.

In our case the Firestone Plantation Company had the right to lease up to one million acres of virgin land from the Liberian government and for the years at issue just under 100,000 acres had been developed into various stages of producing natural rubber trees. In Liberia the private ownership of land is not permitted and the next closest thing to ownership is a 99-year lease which was negotiated between the Liberian government and the Firestone Plantation Company which was coupled with a planting agreement.

A minimal rental fee was provided in this lease agreement. The denominator of the worldwide property factor was therefore devoid of any meaningful value representing the nearly 100,000 acres of plantation. Couple this with the low wage rates in Liberia and two of the three apportionment factors were therefore grossly distorted to the disadvantage of Liberia operations and to the advantage of California and other jurisdictions. Most state statutes provide for the use of eight times annual rental to represent the value of non-owned property. However, in this instance as in the case of McDonnell Douglas' government owned equipment, the property factor was void of any meaningful value for tangible property responsible for the generation of the income to be apportioned. In our case, the state refused to place any reasonable value on this property as for adjustment to the property factor. The lack of a value in the denominator representing the value of leased land with producing rubber trees, coupled with no adjustment for the wide disparity in wage rates paid in Liberia and California results in gross distortion of the income away from Liberia to the United States and ultimately to California. These and a variety of other distortions resulting from the application of the "California Unitary Concept" to the "Worldwide" income of Firestone and its majority owned foreign investments had the effect of shifting income reflected as profit (before taxes) on the books of the foreign subsidiaries to the California apportioned income base and subjecting it to double taxation; first by the country where earned, then as apportioned by California.

A specific example in our case was Argentina for the year 1963. When the California system is applied to calculate Argentina's income, it would apportion $1,832,000 in taxable income to Argentina. "Profit before tax" reported on its books (and upon which the Argentine subsidiary paid corporate income taxes to the Argentine government) was $6,364,000; a difference of $4,532,000. In summary, approximately 71.5% of the book income of the Argentine subsidiary was sujbect to double taxation. Similar calculations for 18 foreign companies at issue with aggregate book incomes (upon which taxes were paid to the various foreign governments) totaled $42,295,000 whereas the three-factor formula employed by California would have apportioned only $13,308,000 of the total to the foreign jurisdictions. The difference, $28,987,000 of the total (nearly 70% of the total) was subjected to the double taxation which was condemned by the United States Supreme Court in Japan Line, Ltd. To what forum does a taxpayer in this situation turn for redress?

C. Other States Tax Foreign Source Income by Defining it "Business Income"

By statute or regulation many states define dividend, interest, technical fees, royalties, capital gains and other foreign source income as business income and subject to formulary apportionment. Some tax only certain of the types of income listed above and some subject a specified portion of certain items to apportionment. Also, there are some states like Ohio which tax no foreign source income.

Recent court decisions have upheld the right of states in which the taxpayer has nexus to tax foreign dividends where the taxpayer is deemed to be "a unitary" business. However, if no foreign factors are added to the taxing states apportionment formula, none of the foreign dividends are attributed to the jurisdiction where the income from which the dividends are paid is generated or earned. Likewise, none of the foreign dividends would be ascribed to the domicile of the payor corporation. This specific point was recognized in the case of Mobil Oil Corporation v. Vermont Commissioner of Taxes by Justice Stevens in his dissenting opinion:

> "Clearly, it is improper simply to lump huge quantities of investment income that have no special connection with the taxpayer's operations in the taxing State into the tax base and to apportion it on the basis of factors that are used to allocate operating income" . . .

Mobil Oil Corporation did not raise the question of adjusting the Vermont apportionment formula when including the Foreign Dividend Income.

Like Vermont many states include foreign source income in their "apportionable income base" either on the basis it is "Business Income" or "Apportionable Income of a Unitary Busines and fail to adjust the apportionment formula to include factors the foreign payor's which are responsible for generating the in in question. This clearly and in many cases grossly distorts the income apportioned.

III. Conclusion

For years tax administrators, multi-national companies, the courts and the Congress have struggled with the problem of how to bring uniformity to the taxation of foreign source income by the states.

The Unitary Concept even became a tax treaty controversy in the US/UK treaty negotiations and is a serious concern of many of our trading partners around the world. Many state tax administrators strongly objected to placing state tax restrictio in tax treaties as they considered this was more properly the concern of Congress and should be handled by the full legislative process. There can be no doubt Congress has been given the authority through the Commerce Clause of the Constitution. There also can be little doubt that taxation of foreign source income by the individual states has become a matter of international concern. Therefore, it is certainly an appropriate matter for Congress to address.

S. 1688 would conform the state rules to the Federal rules within the very narrow areas of 1) the time at which states tax the foreign source income of foreign affiliates, and 2) the quantity or portion of foreign source dividends which are taxed. This legislation is essential now if there is to be an acceptable and uniform system for the taxation of interstate and foreign commerce by states and local governments.

We strongly urge your Committee to give your support to the bill. It is of vital concern to Firestone and to other multi-national corporations to have this assurance for a fair, equitable and uniform standard for the taxation of foreign source income.

International Earnings: State Taxation and the Use of Apportionment Formulas

Statement of the Committee on Finance, Senate of the United States in connection with S.983 and S.1688, June 1980.

C. Lowell Harriss, Professor of Economics, Columbia University; Economic Consultant, Tax Foundation, Inc.; Associate, Lincoln Institute of Land Policy. Views expressed are the author's and not necessarily those of any organization with which he is associated.

Congressional action on state use of the "unitary" approach in taxing the earnings of corporations operating internationally raises the question "Where does income originate? This question should receive explicit attention in formulating policy on the taxation of international and also interstate business.

Origin versus destination arises as an issue in commodity taxation. Residence versus citizenship appears in taxing personal income. Corporation earnings present special complexities when more than one jurisdiction imposes tax--tax not on property, not on sales, not on purchases, not on wages, but on income.

The Nature of Corporate Income Taxation

Although all taxes fall on human beings, this reality is often evaded. The corporate income tax presents a clear example. "Business," the "corporation," must turn over tax money to government. Who is supposed to bear the burden?

The state tax on (or measured by) corporate income is not designed to e a tax on consumers. The tax has never, so far as I know, been supported s a way to burden employees. Nor has the state corporation income tax been esigned to apportion burden according to the residence of the shareholders; uch would be administratively impossible.

What, then, is the presumed intent of state lawmakers in raising revenue y corporate income taxes? The goal, it seems, is to place burdens on hareholders--on the suppliers of equity capital--regardless of whether they ive in or out of the state. The tax stands as a burden on "the corporation" ccording to earnings in the state (assuming that the state has jurisdiction nder the U.S. Constitution) with the actual load hidden from the shareholders ho suffer.

Separate accounting is not always acceptable for companies operating in ore than one state. Generally, therefore, the state's tax will be based n the earnings of the enterprise as a whole with apportionment to the state. I ignore here the practices covered by allocation in its technical sense.) ome form of three-factor formula--property, payroll, and sales--is widely sed. The various formulas are recognized as arbitrary--of necessity. lthough inevitably arbitarary, a formula can conform more or less closely o economic reality.

In considering the application of Federal rules to state taxation of nternational earnings, Congress might give explicit attention to those factors hich are the *source* of what is the base of the tax ("profit" or "net income").

Equity Capital as the Source of Profit (Corporate Income)

Corporate profits are the fruits of equity capital--one of the factors of production. Other factors of production also get paid for what they produce.

The services of employees are compensated; wages are generally taxed in the state where the work is performed. As a source of corporate profit in a specific state, wages or payroll (large or small relative to the company's entire payroll) will be related chiefly to the capital used in payments to employees. The use of payrolls in apportionment formulas does have some logic. As a state-by-state "locator" of profit the payroll factor will probably not give guidance far from underlying reality for a company although the true justification is probably less than actually assigned.

Sales, though a "factor" in formulas, are not a factor of production. The sales element in apportionment formulas does not have the support of logic on anything like the scale of its use. The place of sale has minimal significance as an indicator of where the profits of an extensive organization are produced. (Such is especially true when destination as distinguished from origin is the determinant of the location of sale.) Would stepping across a state boundary represent much of economic significance? Scarcely. Yet under state apportionment formulas it could assign tax one place rather than another.

The attitudes so generally cited in defense of a sales element deserve attention. Perhaps apportionment can be put on a more accurate basis. The

elling corporation provides something of value for which it is paid. The
uyer gets the product or service. The transaction is presumably of mutual
enefit (though not all sales result in profit). The buyer is better off
ecause of the production transportation, marketing, and so on, of the multi-
tate or multinational corporation. What he paid may or may not include
rofit to the corporation. Be that as it may, the act of sale itself is part
f the total process of production in the economic sense. Some of the
eller's capital is probably used in the selling stage; some labor of the
orporation's staff may be applied at the point of destination--though not
lways, e.g., shipment F.O.B. by a common carrier. The discussions of
nterstate taxation frequently assert that the state of sale "creates the
arket without which profitable production would not be possible." What is
he economic significance of such an assertion? (Constitutional arguments
bout nexus are beyond the scope of my testimony on this occasion.) Some
ultistate companies selling in a state have profit while others selling
n the same "economic climate" incur losses. Just what does the state pre-
umably create or provide? And provide to the profitable corporation's share-
olders wherever they live as distinguished from residents of the state who
et the goods and services at prices freely paid. Results of positive
alue accrue to the benefit of residents of the state. Do they somehow get
ore value (for which they pay a profit-yielding price) because of state
overnmental services?

As a basis for apportioning income, the location of sale (especially as destination) does not indicate the "where" of the production of a corporation's income. Recall: This is not a sales tax.

State X, the destination of sales of products from State A, does not attempt to tax the wages paid in state A. State X will not apply its income tax to the interest on debt from lenders in state B used to finance the operations in A which eventually supply people in many states, including X. Thus the destination of a corporation's sales is recognized as irrelevant for the taxation of the wages and interest on debt which it pays. Most states, however--state X in this illustration--do claim the right to tax some of the fruits of equity capital if there is payroll or product delivery (sales on destination basis).

Location of Capital in Apportionment

The amount of earnings apportioned to a state for tax purposes should be measured by the location of equity capital. It is such capital which is being compensated in the form of capital.

Typically, however, there is no measure of the location of those assets which are financed out of the equity capital of a multistate or multinational corporation. The location of property may well be determinable within a tolerable range of accuracy. Some or much of the property may, of course, be financed by debt or leasing. Despite problems, including the arbitrariness of rules used to capitalize rentals, using the total of property per state for apportionment seems likely to lead to reasonably accurate measures.

However, more precise identification may sometimes be possible, as for corporations in more than one country having distinguishable equity financing. Economic logic would then suggest that separate accounting would give more accurate measures than would an arbitrary formula. We know, however, of state complaints about artificial accounting and must recognize the substance of a real problem.

In any case, the specific difficulty will not be met by the use of sales in an apportionment formula. Sales do not serve to locate the earnings of capital. The property factor comes closest to what is needed, and efforts should be directed toward apportioning property as accurately as possible.

State officials may feel that a proposal for revising the formula is an attack on the amount of revenue obtainable. In specific corporate situations there will be a difference with lower tax the result of one as against another formula. Generally and over all, however, total revenue depends upon total corporate profit and state tax rates. (Protectionist, tariff-like manipulations may in fact be a goal; there may be a desire to hamper out-of-state as against in-state activities.)

State attempts to tax on a world-wide basis will raise many issues beyond the one touched upon here--the economic logic of the apportionment formula. What deserves emphasis, I believe, is this conclusion: The wider the scope of a state taxation, the greater the importance of economic rationality in the apportionment formula.

Revenue Autonomy for States

The purpose here is not by any means to advocate the adoption of a new basis for formulas to reduce either total state revenues or the total burden on corporations. States obviously have power to adjust tax rates.

What Congress can do is to employ Federal authority to influence and systematize the state taxation of earnings of interstate and international enterprises. One potential does seem worthy of attention. Since the tax falls on the earnings of equity capital, the liability for tax should be identified as well as possible with the location of property as the source of profit. The sales element does not belong in a formula for locating the income of corporations (except for the capital involved in the selling process, including warehousing and the holding of inventory).

Considerations of states rights must be weighted against benefits and burdens from Federal use of the power to make treaties and to regulate interstate commerce. To some extent, certainly, the people of one state have an interest in the actions of legislatures in other states. A voter in one state has no power to protect his or her interest in actions of other states or nations except through Congress and the treaty process.

The efforts of states to tax interstate and international income will, I suggest, be most constructive if they follow the economic counterpart of "natural law." The goal should be taxation that conforms to economic reality rather than induces distortions and malallocations. To the extent that corporate earnings are taxed apportionment should emphasize property.

FINANCIAL EXECUTIVES INSTITUTE
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July 10, 1980

The Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on Taxation
and Debt Management
Finance Committee
United States Senate
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Byrd:

Pursuant to Press Release #H-31, the Committee on Taxation of Financial Executives Institute submits this written statement for insertion in the record of the hearings held on June 24, 1980 on Senate bills S983 and S1688.

We support passage of S1688, a bill to limit state taxation of foreign source income. We also support S983, a much broader bill. Our emphasis, however, is on S1688: if enacted, it will be a positive first step toward resolution of the myriad problems of state taxation of interstate and foreign commerce which have been before Congress continuously for fifteen years.

The need for action by Congress is shown by the many occasions on which issues involving state taxation of interstate and international commerce have been brought before the U.S. Supreme Court. The Court has frequently declined to mandate restrictions on the states in their assertion of extraterritorial taxation. At the same time, it has stated that the responsibility lies with the U.S. Congress to enact appropriate legislation in this area of taxation.

Financial Executives Institute is the professional association of 11,000 senior financial and administrative officers of 6,000 organizations, large and small, throughout the United States and Canada.

The Court's view was amply described as long ago as 1959 by Justic Frankfurter in his dissenting opinion in a U.S. Supreme Court decision* in which he stated:

> "I am not unmindful of the extent to which federal taxes absorb the taxable resources of the Nation while at the same time the fiscal demands of the States are on the increase.... In fact, relying on the courts to solve these problems only aggravates the difficulties and retards proper legislative solution.... The problem calls for solution by devising a Congressional policy.... The solution of these problems ought not to rest on the self-serving determination of the States of what they are entitled to out of the Nation's resources."

In its decisions on issues involving state taxation of interstate and international business activities, the U.S. Supreme Court has consistently followed a line of reasoning emphasizing the more limited powers of the states to tax their residents or citizens in comparison to a broader power of the federal government to tax the worldwide income of its residents or citizens. In every case, the Court has posed the question of whether there was an interrelationship between a taxpayer's in-state activities and activitie outside the state. The establishment of such a relationship is necessary in order for a state to levy a tax on an activity as remuneration for services rendered or protection provided in regard to the carrying out of the activity.

Dictum of the U.S. Supreme Court, therefore, indicates that states should not tax foreign source income unless there is an interrelationship between the activity giving rise to such income and a business activity in the state. Acting upon this fundamental principle, it would be appropriate for Congress to enact legislation which would provide an outright prohibition against the taxing of foreign source income by the states.

S1688 does not attempt to place such an absolute prohibition upon the states. It would simply conform state rules to the federal rules within the very narrow areas of (1) the time at which states tax foreign source income of foreign affiliates, and (2) the quantity or portion of foreign dividends which are taxed. States will not be effectively precluded from taxing a greater portion of foreign source income than is taxed by the federal government unless S1688 is enacted in its entirety.

The sections of S1688 which prohibit the states from combining the income of a corporation operating within a state with the income of its affiliated foreign corporations accomplish the

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* Northwestern States Portland Cement Company v. Minnesota, 358 U.S. 450 (1959).

following:

(1) The affiliate's foreign source income is not exposed to state taxation until it is brought into the United States in the form of a dividend.

(2) To the extent that the entire income of the affiliate is not declared as a dividend, that portion of the foreign source income which is reinvested outside the United States does not become subject to taxation by the states.

In effect, these limitations on combined reporting invoke upon the states the federal practice of not taxing income of a foreign affiliate until repatriation and receipt as a dividend.

The dividend sections of S1688 are necessary to prevent the double taxation of the repatriated income -- first, by the foreign country in which the income was earned and, again, by the states. Unlike the federal government, states do not allow a foreign tax credit. The exclusion formula included in S1688, therefore, conforms the portion of income taxed by the states to that taxed by the federal government after allowance of the foreign tax credit.

It is for the foregoing reasons that our Committee on Taxation of Financial Executives Institute urges the enactment of S1688, without amendments or deletions.

Sincerely,

Donald K. Frick

Donald K. Frick
Chairman, Committee on Taxation
Financial Executives Institute

cc: Michael Stern, Staff Director,
Senate Committee on Finance (five copies)

National Retail Merchants Association

NRMA

1000 Connecticut Avenue, N.W.
Washington, D.C. [illegible]
[illegible]

Written Statement

Of The

NATIONAL RETAIL MERCHANTS ASSOCIATION

On The

Taxation of Interstate Commerce

* * *

Submitted To The

Subcommittee On Taxation and Debt Management Generally

Of The

Senate Finance Committee

* * *

June 24, 1980

The National Retail Merchants Association (the "NRMA") submits this statement on S. 983, introduced by Mr. Mathias, to establish a system for the uniform taxation by the states of interstate commerce. The NRMA is a non-profit, voluntary trade association representing approximately 33,000 general merchandise outlets throughout the United States. Our membership includes all of the nationally known chain and department stores, as well as numerous smaller, independently-owned retail establishments. As the annual aggregate sales volume of NRMA members exceeds $95 billion, our sales generate billions of dollars

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of sales and use taxes. Our members employ, on a regular basis, in excess of 2 million people.

The NRMA supports the Mathias Bill as a reasonable effort to achieve uniformity in state and local taxation of interstate commerce, and as an administratively workable solution to the problems presented by the patchwork of state and local tax laws that currently afflict large and small retailers alike. Our specific comments and suggestions are set forth in accordance with the numbering system used in the Bill.

TITLE I: SALES AND USE TAXES

Section 101 -- Uniform Jurisdictional Standards

The NRMA approves the adoption of a uniform state jurisdictional standard based on the Supreme Court decision in Scripto, Inc. v. Carson, 362 U.S. 207 (1960). The Bill properly refuses to extend jurisdiction where the seller's only contact with the state consists of direct mail solicitation or advertising by means of printed periodicals, radio, or television. Occasionally, however, a seller may have a physical presence, albeit a temporary one, in a jurisdiction where a representative is, for example, negotiating agreements for local advertisements in local news media. The Committee Reports on the Bill should make clear that activities ancillary to activities which under the Bill do not in themselves subject the seller to a state's jurisdiction should not confer jurisdiction on the state to tax the seller. Further, the Bill should add the word "newspaper" after "printed periodical" as some states take the position that for certain purposes newspapers are not printed periodicals.

Section 102 -- Reduction of Multiple Taxation

This section of the Bill permits states to enter into agreements ("compacts") requiring the collection by a seller in one state of the sales or use tax of a second state, notwithstanding the absence of a jurisdictional nexus to the second state otherwise required by Section 101 of the Bill. Significantly, the permission to enter into compacts is not limited to contiguous states; any two states, no matter how far distant, could require a reciprocal collection of tax by non-resident sellers.

The permission given to non-contiguous states to enter into compacts has great potential for unfairness. In addition, the NRMA questions the amount of revenue gain to be derived from this measure as it applies to non-contiguous states, and believes that the cost of compliance to the retail industry would be extraordinarily high. Accordingly, we recommend that if any provision granting states the right to enter into reciprocal collection compacts is acted, it be limited to contiguous states only. Moreover, ere would appear to be substantial due process questions any measure which requires a retailer without any juris- ctional connection to a particular state, whether contig- us or otherwise, to collect that state's sales or use tax. e sales and/or use tax collection burden is properly upon rsons subject to the jurisdiction of the taxing state.

The NRMA strongly supports Section 102(d) of the ll, which would allow a user of taxable property a edit against use tax liability for the amount of any les or use tax previously paid with respect to the same operty on account of liability to another state or politi- l subdivision. However, in two important situations the edit provision does not go far enough: where a user has id sales tax to a vendor but where the vendor was not, fact, required to collect such tax, or, where the vendor s failed to remit the tax either at all or to the appro- iate taxing jurisdiction. For example, a buyer may have id sales tax to a State X vendor, but the property may delivered to the buyer's branch office in another state tate Y) and the vendor may remit the tax to the buyer's me office state (State X). In this case, although the yer-user in good faith attempted to discharge its tax abilities, it may not, under this subsection, be entitled to a credit because the tax would be deemed either not "paid" or not paid on account of a "liability" to another state or political subdivision. The Bill, accordingly, should provide a method of protecting the taxpayer against liability to two different jurisdictions, each asserting primary jurisdiction with respect to the same property or transaction. The NRMA recommends that this Subsection be clarified so that credit be allowed for sales or use tax previously paid to a state or vendor, and for such tax paid in respect of a good-faith belief as to a liability to any state.

TITLE II: GROSS RECEIPTS TAX

Section 201 -- Uniform Jurisdictional Standard

The principal comment on this provision relates to the application of state gross receipt taxes to gross receipts derived from tangible assets closely associated with sales -- specifically, service charge income. The Bill's focus is quite properly limited to the states' ability to tax in the context of interstate commerce, and the Bill accordingly speaks in terms of tangible personal property. Multi-state vendors, however, are subject to inequitable taxation (net income - gross receipts) to the extent that with respect to one state service charge income is included in allocating gross income for net income tax purposes, but a second state also includes such charges in gross receipts not subject to allocation.

The Bill should provide that the appropriate jurisdiction to impose a gross receipts tax with respect to finance charge income is the state where the services generating the finance charges are rendered. This could be done by adopting the language as contained in the Bill, Title III, Section 357(b)(2).

TITLE III: NET INCOME TAX

The NRMA supports this Title of the Bill as properly clarifying the application of the three-factor apportionment formula and the extent to which a state, or a political subdivision thereof, may tax income derived by a corporation which has business operations in more than one state. At the same time, the Bill provides reasonable flexibility to each state to determine what it believes to be its appropriate share of a corporation's interstate income. Thus, for example, the legislation continues to allow a state -- within broad statutory limits -- to permit separate accounting.

In sum, the NRMA considers that the income tax provisions of the Bill, if enacted, promote uniformity and objectivity by placing a ceiling on the amount and type of income derived in interstate commerce which could be subjected to tax by a state, while at the same time enhancing the ability of the states to impose taxation as needed to support their own economies.

The NRMA emphasizes the necessity of including within the definition of excluded corporations financial companies "affiliated" with a retailer. Such financial subsidiaries should be excluded along with banks and similar financial institutions from a combined or consolidated report, since the same rationale for excluding banking subsidiaries from a combined or consolidated report applies to such financial subsidiaries. The inclusion of such a nonmercantile business in a combined or consolidated report consisting primarily of retail companies would distort not only the application of the apportionment factors, because of the totally different method by which financial subsidiaries operate, but also the affiliated group's financial picture, as financial subsidiaries are engaged in a business wholly distinct from that of the related retailer, and their economic health may be countercyclical with respect to the retailing arm of the same business.

The NRMA also supports Section 302 of the Bill, dealing with foreign source income, but would find the approach taken in S.1688, also introduced by Mr. Mathias, as an acceptable alternative.

CONCLUSION

The NRMA believes that enactment of the Mathias Bill is absolutely essential to the fair and equitable treatment of both multi-state and local retailers. Moreover, the complexity and unfairness of current laws places a heavy burden on interstate commerce.

Because retailers are a significant factor in the generation and collection of sales, use, income and gross receipts taxes, we believe we should be included in any meetings or hearings on this matter, and would be pleased to assist in any way possible to achieve passage of the Bill.

STATEMENT ON BEHALF OF EXXON COMPANY, U.S.A.
A DIVISION OF EXXON CORPORATION
FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
HEARINGS ON S. 983 AND S. 1688

STATE INCOME TAXATION OF MULTISTATE AND MULTINATIONAL BUSINESSES

The June 10, 1980 decision by the Supreme Court of the United States in Exxon Corporation v. Department of Revenue of Wisconsin again demonstrates the reluctance of the Court to establish precise guidelines for determining how much of the income of a multistate corporation may be taxed by each state in which it does business.

Exxon has been deeply concerned for some time with the numerous controversies which arise from the inconsistent and overlapping rules now used by the states in dividing the income of companies like Exxon which do business in more than one state.

In the mid-1960s the Company supported the efforts of a group of states to establish the Multistate Tax Compact to:

1. Facilitate proper determination of state and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes.
2. Promote uniformity or compatibility in significant components of tax systems.
3. Facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration.
4. Avoid duplicative taxation.

Efforts by representatives of the business community and the states to develop a consensus on how to achieve these goals failed, and were marred by the ensuing charges and countercharges which provided much heat but little light on the subject. Business contended that the states were seeking maximum tax revenue without regard to "equitable apportionment", while the states charged business with trying to avoid its fair share of taxes. When it became apparent that the states and the business community could not resolve the problem through the Compact mechanism, Exxon decided to make an all out effort to establish equitable income attribution guidelines through the courts or at least expose some of the basic inconsistencies in state taxation in hopes of contributing to a reasonable solution. It was recognized that the U. S. Supreme Court might well take the position that the division of corporate multistate income was primarily a legislative policy issue and uphold any state method of income attribution bearing a "rational relationship" to activities within the state regardless of consistency with methods used in other states. Although the Supreme Court did not go that far in Exxon's Wisconsin case, it nonetheless upheld the state's methodology without regard to potentially overlapping state taxation.

In view of the reluctance of the Supreme Court to resolve the problem of the growing divergence and resulting overlap in state income attribution rules (e.g., adoption by Alaska of separate accounting treatment for oil and gas production and pipeline transportation and by Wisconsin, New York, Massachusetts, and Florida of a double weighted sales factor to increase their respective shares of total income) Exxon has concluded that federal legislation offers the only viable solution. However, before addressing the specifics of a solution, it would appear desirable to review development of the current situation.

Background

The determination of what portion of the income earned by a multi-state corporation is attributable to a particular state in the U. S. has been debated since the inception of taxes on net income. At first, the states generally determined taxable income by means of "separate accounting" with each corporation treated as a separate taxable entity and the income and deductions specifically attributed to operations in each state. Gradually, states began shifting to a formula apportionment of the total business or operating net income of each corporation usually based on the ratio of property, payroll and sales within the state to total property, payroll and sales everywhere. California went further and combined the world-wide operations of all affiliated corporations for purposes of determining the income of those members doing business in California. Several other states now follow California's combined reporting approach.

At the present time, most states determine income attributable to the state by use of a 3-factor (property, payroll and sales) formula applied to the taxable income from operations of each corporation doing business within the state, while a handful combine the operations of an affiliated group and apply the 3-factor formula, and a few require separate accounting for particular activities such as mineral extraction (e.g., Alaska). Many states specifically allocate "nonbusiness" or nonoperating income, such as rents, dividends, and interest, on the basis of situs, commercial domicile, etc., although the trend is toward apportionment of such income. Each method of income attribution has its advantages and disadvantages and none are perfect for all situations.

Separate accounting permits recognition of differing rates of profitability among different activities or locations of a taxpayer, but to some, it involves too many problems as to proper assignment of income and expenses on a geographical basis.

Formula apportionment has met with the widest acceptance because many feel it is easier to administer. On the other hand, formula apportionment arbitrarily assumes that each dollar of property, payroll and sales earns the same rate of profit, thus leading to considerable distortion of the facts are otherwise. For example, some businesses are far riskier than others and require a higher prospective rate of return to attract the necessary capital. Moreover, if a corporation begins operations in a new state and suffers start-up losses for several years until the market is effectively penetrated, the formula will nonetheless attract part of the income from profitable operations in other states and deflect most of the start-up losses to points beyond the borders of the newly-entered state. Similarly, inflation distorts the income attribution if there is considerable difference in the age of assets included in the property factor.

Far more important than the merits of each method of income attribution is their consistent application by all states in which the taxpayer does business. If different states "whipsaw" the taxpayer through use of different attribution methods, overlapping taxation tends to result. For example, to the extent that crude oil production and transportation income attributable to Alaska under its separate accounting rules exceeds the amount which would be assigned to Alaska under the apportionment formula used by the states (e.g., California) in which the crude oil is ultimately sold, such overlap exists. Using data from the comparative state tax burden study prepared by Arthur Andersen & Co. for the Alaska Oil and Gas Association, it would appear that the potential Alaska "whipsaw" effect could exceed $15 billion in overlapping income for the four principal Prudhoe Bay operators over the life of the field.

Some states have expanded formula apportionment from a separate corporation basis to combine all of the members of an affiliated group to form a single tax base on the premise that affiliated corporations are no different than branches or divisions of a single corporation and should be handled in the same manner. California would contend, for example, that it should make no difference for state income tax purposes whether a U. S. petroleum corporation conducts its U. K. North Sea operations through a division of the same corporate entity, a separate U. S. subsidiary, or a U. K. or other foreign subsidiary. By combining all members of the affiliated group, such distinctions are eliminated.

On the other hand, combining foreign affiliates with U. S. corporations compounds the potential distortion inherent in formula apportionment because of differences in accounting methods and tax structures at home and abroad. U. S. financial and tax accounting concepts would have to be substituted for those of each foreign country to achieve an internally consistent combined income base to which the apportionment formula could be applied.

Recognition must also be given to structural differences between the U. S. federal system of government with its many layers of taxation at the federal, state and local level, and foreign systems which may be more or less centralized and rely on a different mix of taxes. For example, a California corporation doing business in Country A which raises all revenue through a single 50% national income tax may derive the same after-tax net income as from operations in Country B which raises its revenue through a single national excise tax. Although the after-tax net income is the same in each country, the taxpayer would have to report twice as much income from operations in Country A as in Country B in calculating the California tax on income because that state does not allow a deduction for income taxes, but does allow a deduction for excise taxes.

Efforts by California and others to combine the worldwide operations of foreign-based affiliated groups doing business within the state have met with considerable resistance from abroad and led to an unsuccessful attempt to limit such practices in the U.S.-U.K. Tax Treaty recently ratified by the Senate. While there may be disagreement as to whether the treaty process is an appropriate way to impose limitations on state taxation, it is clear that some limitation is needed in view of the continuing efforts to combine worldwide affiliated operations and the growing divergence in state income attribution rules.

Position

Exxon has consistently expressed its willingness to expose all of its U. S. source income to state taxation provided there are adequate safeguards to prevent overlapping or duplicative taxation of the same income. To avoid such overlapping and duplication, Exxon supports a reasonable federal limit on the portion of a taxpayer's income that may be attributed to a particular state. To avoid distortion and to spare foreign (non-U.S.) corporations an unnecessary recalculation of income for U. S. state tax purposes, it would be appropriate to eliminate from any combination affiliates not doing business in the U. S., and to allow states to tax only U. S. source income determined under the federal income tax sourcing rules. The desire of the Internal Revenue Service to maximize U. S. source income for federal tax purposes would seem to offer adequate protection to states.

A state would then be permitted to attribute income to operations within its borders by whatever method it chooses so long as that amount did not exceed a limit calculated by applying to U. S. source income determined under the Internal Revenue Code the equally weighted average ratio of property, payroll and sales within the state to total property, payroll and sales within the United States. Such a limitation would simplify tax administration, avoid overlapping taxation, and permit each state to tax its share of domestic income without the controversies inherent in the present attribution rules.

In general, the provisions of Title III of S. 983 by Senator Mathias appear to provide a suitable framework for developing a workable limit consistent with the criteria set out above. We do believe that if a distinction is to be made between apportionable and allocable income, it should be more precisely defined to avoid a potential "whipsaw" effect between apportionment for a particular item of income in one state and allocation of that same item in another state. One approach to a definition of "apportionable income" would be an adoption of the "business income" definition used in the Uniform Division of Income for Tax Purposes Act (UDITPA) coupled with an enumeration of items which are specifically allocable. However, the "business" nomenclature should not be used in view of the inherent ambiguity of that term. We would also recommend that coverage be broadened to include common carrier petroleum pipeline operations within the protection of the limitation provisions.

In summary, Exxon urges the adoption of federal limitations on the attribution of income from multistate business operations to particular states.

July 10, 1980

STATEMENT OF THE BUSINESS ROUNDTABLE
WITH RESPECT TO
S. 1688
SUBMITTED TO THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
JULY 10, 1980

There are a number of complex issues involving the taxation of businesses by the various States which will require legislative study and solutions in the future. Many of these problems are addressed by S. 983, a bill which has substantial support in the business community. S. 1688 does not resolve all of the existing problems inherent in state taxation of interstate and foreign commerce. However, it would solve several very pressing state tax issues for both American companies and their foreign trading partners by clarifying the extent to which a state, or political subdivision, may tax certain income fro sources outside the United States. The Business Roundtable (the "Roundtable") supports and urges the enactment of S. 1688 and is pleased to present its views on this proposed legislation.

S. 1688 is based on the principle adopted by the Ways and Means Committee Task Force on Foreign Source Income in 1977 when it recommended that the States be precluded from taxing the income of foreign affiliates "under the unitary method or any other method . . . until such time as that income is subject to Federal income tax."

S. 1688 would prohibit the States from taxing any income of a foreign affiliate of a corporation doing business in the United States unless that income is subject to tax by the Federal Government. In addition, dividends received from a foreign corporation are exempt from State tax to the extent they are not taxed by the Federal Government.

The legislation would, therefore, prohibit worldwide combined unitary reporting. It would relieve both United States and foreign-based businesses of the inequitable tax burden imposed by a minority of States and undoubtedly would be welcomed by our trading partners.

The worldwide combined unitary tax system creates the following overriding problems:

- It is discriminatory and offensive to foreign governments and foreign investors in the United States.
- It impedes foreign investment in the United States by creating uncertainty and inconsistency on what will be taxed.
- It can result in double taxation of income.
- It is inequitable because it can result in a disproportionate share of income being allocated to the taxing State.
- It is inconsistent with traditional and international standards of taxation, which are based on the arm's-length standard.
- It creates a threat of retaliatory action by our trading partners.
- It places enormous and costly administrative burdens on business.

The application of the worldwide combined reporting system by States has become an international issue adversely affecting our relations with our trading partners and the climate for foreign investment in the United States. We are the only major country that uses this tax system. Our major trading partners are finding this an increasing problem, and our position of leadership in the world requires affirmative action to eliminate this tax system before it spreads to other States or countries.

Foreign governments, foreign investors and responsible international organizations have expressed their serious objections to the unitary system. They point out that this system taxes profits which are earned outside the United States and are not attributable to operations in the taxing States.

The protracted negotiations surrounding the United States - United Kingdom Tax Treaty are familiar to the subcommittee. That treaty was signed December 31, 1975, but the formal exchange of documents did not take place until March 25 of this year. The treaty was held hostage to this problem for years by States insisting on eliminating a clause which would have prevented application of this tax system and, then, by strong British opposition to the treaty, which was silent on this issue. United States and British taxpayers were the victims as the treaty benefits for taxpayers of both countries were delayed. Practical financial planning of business was difficult and other problems, which should have been solved by now were left unresolved.

At the exchange of documents on March 25 the British Ambassador announced that he had filed a note with the State Department expressing that the United Kingdom was "gravely concerned." It said "... the unitary basis of taxation with combined reporting, particularly as applied in the international field, is entirely unsatisfactory" and that "the tax consequences are unpredictable and arbitrary."

Final approval of the treaty without the unitary tax clause was given by the House of Commons with the understanding and expectation that Congress would address this problem. Mr. Roger Moate, M. P., speaking in the House of Commons on February 18, 1980, during the debate before final ratification of the treaty, summarized the feelings of the British at that time:

"I hope, therefore, that if we agree to the motion tonight and if the Government proceed to ratify the treaty, those in the United States Senate will understand that we are doing so on the basis of trust and are placing an immense amount of faith in the proposals about which we have heard and in the Senate's determination to rectify what is a grossly unsatisfactory situation."

Failure of the United States to resolve this problem threatens the future of the treaty.

Nor is Great Britain the only trading partner expressing concern about the application of the worldwide unitary tax method by the States. The French Government has stated, in an exchange of notes accompanying a protocol signed November 24, 1978, that the worldwide combined reporting method "results in inequitable taxation and imposes excessive administrative burdens on French corporations..."

The strong reactions of the French and British Governments represent two concrete examples of the dissatisfaction among our foreign trading partners caused by the use of this method.

It should also be noted that the position of the Organization for Economic Cooperation and Development, in which our major trading partners hold membership, opposes use of the unitary method.

In addition to these international entanglements, this tax system deters foreign investment in the United States. This debate comes at a time of national concern over capital formation, economic growth and lagging productivity in the United States. The Roundtable believes that we should be encouraging foreign investment to enhance capital formation, create jobs and improve the balance of payments. The passage of S. 1688 will eliminate an important deterrent to such investment.

American business is burdened by this tax system when States tax an inequitable portion of the income of foreign subsidiaries and dividends from other foreign investments. It must be remembered that American business does not incorporate abroad in order to avoid State taxes. We set up companies in foreign countries to develop business that would not otherwise be available to us. Foreign markets offer significant opportunities for United States industry and should be encouraged, not burdened by a State tax system that may result in unrelieved double taxation and excessive administrative costs.

This legislation will provide for uniform and equitable taxation of foreign source income and eliminate an area of controversy that has given se to costly litigation in recent years. The application of the unitary ncept to foreign business creates unfair and inequitable results since it sumes that each dollar of sales, property or wages produces the same ount of taxable income around the world. This we know is not true. This lative imbalance results in overallocation to those States with relatively wer taxable income per dollar of sales, property or wages.

S. 1688 endorses the arm's length method of apportionment by requiring xability at the Federal level as a prerequisite to taxation by the ates. Tax experts generally recognize that although the arm's length thod is imperfect, it is better than the arbitrary apportionments made by e application of the unitary system. It is, moreover, an internationally cepted standard. It has been studied and accepted by the Organization for onomic Cooperation and Development and used by all major trading partners r allocating income and deductions fairly among related companies. Rather an seeking to avoid taxation, corporations are seeking use of the arm's ngth method by States to avoid the administrative burden, the arbitrary xation and the double taxation imposed by the worldwide combined unitary porting method.

Unitary apportionment systems impose severe administrative burdens on rporations. All the financial and operating data for a tax return must be cluded in the combined report of the group. Much of this information is fficult or impossible to obtain from foreign parents or subsidiary companies. Books and records are kept in different languages, different currencies and according to different accounting rules. The problems are compounded by fluctuating currencies and the translation of the accounting records to United States dollar statements. Government programs, fringe benefits and profit-sharing make it difficult to compare payrolls.

A major flaw in the application of the unitary concept to foreign subsidiary or parent companies is that the system ignores foreign taxes paid on the income that is apportioned from the foreign company to the taxing State. Since the foreign country taxes this income, the income is then taxed twice -- once in the foreign country and again in the State -- with no provisions for credit for the foreign taxes.

The negative effect of the worldwide unitary tax on foreign commerce is a matter which must be addressed by Congress. The Supreme Court in the recent case of Japan Line Ltd. vs. County of Los Angeles, 60 L.Ed.2d 336 (1979), discussed at length the need for the Federal government to speak with one voice in matters regulating commercial relations involving foreign governments. The Court stated, at 347:

> "... a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential. Foreign commerce is preeminently a matter of national concern."

The Court summarized the problem created when State and local government taxation encompasses foreign entities, at 352:

> "Even a slight overlapping of a tax -- a problem that might be deemed de minimis in a domestic context -- assumes importance when sensitive matters of foreign relations and national sovereignty are concerned."

Similarly, in Moorman Manufacturing Company vs. Blair 437 U. S. 267 (1978), the Supreme Court declared at 280:

> "It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all states to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decision."

The courts may be able to rectify a clearly demonstrated case of double taxation resulting from the imposition of the worldwide unitary tax by a majority of the States. As a practical matter, however, that may take years. The power of Congress to act in this matter is unquestioned and the need for it to act now is compelling.

We urge the Subcommittee on Debt Management and Taxation to report favorably on S. 1688.

Testimony of New York State Department of Taxation and Finance on S. 983 and S. 1688 before the Senate Subcommittee on Taxation and Debt Management of the Committee of Finance, U.S. Senate Submitted July 10, 1980, Pursuant to the rules of a hearing held June 24, 1980

Introduction

S. 983 by Senator Mathias is a broad bill which limits pow of state taxation in corporate franchise, corporate income, sta sales and use taxation and local sales and use taxation. S. 16 also by Senator Mathias, is a bill which limits powers of state taxation in the corporate franchise and corporate income tax ar only, and is further limited to taxation of unitary businesses the taxation of dividends.

S. 983 has significant and completely unacceptable impacts New York State as currently drafted. S. 1688, while it probably not intended to have a major impact on New York State, does have major flaws which result in significant and totally unacceptable impacts on New York. The flaw in S. 1688, with the most severe impact on New York, is its failure to exclude from its provision specialized corporations, such as banks and insurance companies. Such corporations have not been the source of the national tax problems which this bill presumably intends to resolve.

New York does not object to some reasonable and limited Federal law which would help resolve interstate or international tax compliance problems. However, it does strenuously object to being made part of a solution to problems which we did not creat nor perpetuate, and which reduce our tax revenues as these bills

If Congress is to take away state taxing power, it should, at the very least, preserve existing reasonable methods of taxation and help states resolve interstate tax compliance problems which are of great concern to us. Specifically, we would look to provisions which would expand jurisdictional authority to tax in the corporate franchise or income and state sales and use tax areas. Under no condition should banks and insurance companies be covered in legislation applicable to general business corporations since the business activities and methods of State taxation of such corporations are quite distinguishable from general business corporations.

Specific Objections

Optional Consolidated or Combined Reporting

S. 983 allows a corporate taxpayer the option of whether it will file its tax reports with a state as a group of commonly owned corporations or separately. The bill defines the method as "combined or consolidated" reports, without distinction. There are very significant differences between a consolidated and a combined report in New York State and the mere definition of the two terms as one is incorrect and unacceptable. In New York a combined report is filed by corporations which meet two tests in addition to a common ownership test and when properly filed, receive the benefits of a common formulary division of combined income. In addition, combined reporters eliminate transactions among the corporations properly included in the report.

Under a consolidated report the benefits of common formular apportionment do not exist. That is, the formulary division of income of each corporation in the group is individually determin and the net income of each corporation then attributable to the taxing state is consolidated. S. 983 does not give recognition this important distinction. It treats the consolidated method a if it were the combined method.

The importance of this distinction is that the drafters of S. 983 have utilized the Federal accounting method of consolidate reports, which taxpayers have the option to use, under the Intern Revenue Code, and applied it to a state system of combined report where an option is not appropriate at all. It is not appropriate because of the significant shifting of tax burden which can take place based on the accounting method used. This shifting would be available at the whim of the taxpayer with the exercise of the option to elect combined reporting and applying the apportionment factors of all the members of the combined group to all of their income, pursuant to § 303(a) of S. 983.

No state, to our knowledge, allows a corporation an option t elect such reporting. Some may allow consolidated reporting or allow very limited and specialized elections for combined reporti but none would appear to have the shifting of tax burden effects which are the result of § 303(a).

The tax impact of combined report accounting for state taxes is the reason why well defined rules are needed in addition to common ownership. This is why the unitary business concept exists and why New York State uses, in addition, an objective intercompany transactions, or flow-of-goods test. Neither S. 983 nor S. 1688 contains such tests.

Dividends

S. 983 limits the taxation of dividends to the state of commercial domicile of the corporate taxpayer. It further limits dividends taxation to U.S. source non-subsidiary dividends.

New York and some other states utilize formula apportionment methods to divide dividends and other sources of investment income among taxing jurisdictions. While commercial domicile is a rule which was historically used by states, New York found many years ago, when it adopted its formula method for dividing dividends among taxing jurisdictions, that it was an improvement both from the point of view of local business, those commercially domiciled in the state, and whom we wanted to keep in the state, as well as firms not commercially domiciled in New York who were willing to pay a fair share of their earnings to the places where that income was earned. The U.S. Supreme Court, in the recent case of Mobile Oil Corp. v Commissioner of Taxes, confirmed the validity of formula apportionment of dividends.

The limitations on state taxation of dividends in both S. 983 and S. 1688 suffer from an additional problem, as raised by the U. Treasury Department, because the prohibition on taxing dividends from foreign sources creates an incentive for foreign investment.

Formula Apportionment

S. 983 establishes an equally weighted three-factor formula as the basis for dividing most of the income of general business corporations among state taxing jurisdictions. Most states use a three-factor formula. A few, like New York, use a four-factor formula which, in effect, doubly weight the sales or receipts factor. This weighting gives more importance to the marketing function of income production and assigns that weight to the destination of sales or receipt. Under S. 983 taxpayers are given an option to use either a single-weighted or a double-weighted sales factor formula. New York affirmatively decided, when it enacted its double weighted factor in 1975, not to grant such an option for at least two very important reasons:

1. It did not want businesses in other states to access its market without due consideration; and
2. It could not afford the revenue loss.

We still cannot afford the revenue loss.

In addition, the three-factor formula as defined under this bill differs in several ways from New York's definition of its property, payroll, and receipts factors. While New York is not unwilling to provide taxpayers with the option of those definitions variations, their cost is a burden the state has previously decided not to bear. Those costs are still unbearable.

Sales and Use Tax Jurisdiction

S. 983 codifies for sales tax jurisdictional purposes certain court decisions which have been viewed in past years as the common law limit to a state's right to require collection of sales and use taxes.

This is an attempt to limit the hard fought expansion of the state's rights to require collection of sales taxes (National Geographics Society v Cal Bd of Equalization overruling Miller Bros v Maryland in part, is a case in point) to those situations specifically enumerated in the bill. More importantly, this codification of past case law fails to deal with the current and very real problems of the tax free competition across state lines.

Aside from the loss of revenues to the states involved, such tax free competition places the small business, which this bill purports to protect, at a competitive disadvantage. The bill favors out-of-state mail order and border vendors over small local businesses selling competitive products.

Additionally, under S. 983 jurisdiction of local governments to imposes sales and use taxes is prohibitively restrictive. Section 101(b) of S. 983 prohibits imposition of local (as opposed to state-wide) sales taxes unless a vendor comes within the limits described therein. This section is not limited in scope to inter state sales but is applicable to intrastate sales as well. This constitutes an impermissible limitation of the taxing powers of the state over persons subject to its jurisdiction.

Also, the revenue impact of section 101(b) together with the provisions of § 104(d) and § 105 (which in effect would inhibit proper accounting and allocation of revenues collected) on New Yo State's administration of the sales and use tax in the City of New York, could well cause a default of its major revenue bonding program, commonly known as "Big Mac". The principal revenue sour for these bonds is the local sales and use tax revenue of the City which tax is imposed and collected by the State.

Finally, the sales and use tax provisions of S. 983 are prob technically deficient in extending the jurisdictional limitation (liabilities in effect prior to the bill's effective date.

While some relief from multiple sales and use tax reporting and accounting requirements might be appropriate for out-of-state businesses having minimal contacts with a taxing jurisdiction, no state should be prohibited from imposing state and local reporting and accounting requirements over businesses having real and substantial presence within that state.

The problems of tax free competition across state borders, sa guarding local revenues, and relief to the small business from suc unfair competition and the burden of multiple reporting requiremen might be resolved if considered in the context of expanded sales and use tax jurisdiction, rather than as a limitation on such juri diction as in this bill.

Sales tax jurisdictional issues and the problem of tax free competition across state borders may be dealt with by a codification of jurisdictional limitations which would overrule the decision of National Belles Hess v Illinois (1967) (which problem is completely ignored by S. 983). Such a codification would subject mail order companies to sales or use taxation in the jurisdiction where goods are delivered.

In addition, it is the opinion of the New York State Department of Taxation and Finance that even broader Federal jurisdictional rules should be enacted by Congress to require collection of tax by border state vendors regularly soliciting in our market via printed periodicals, radio and television, in addition to direct mail advertisements. It is quite reasonable to expect that this area of expanded jurisdiction would not subject any newly covered vendors to burdensome reporting requirements.

In exchange for such expanded jurisdiction and as an alternative to the certification process provided in S. 983, which was to provide a simplified procedure to avoid reporting requirements for small vendors, the following alternatives are suggested (in order of preference):

1. Limit the expanded sales tax jurisdiction (other than mail order jurisdiction) to those vendors making deliveries from states contiguous to the taxing jurisdictions;

2. Provide that vendors required to comply with the expande
state and local jurisdiction need collect and remit a single
statewide rate only, leaving with the state the option to
determine what that single statewide rate would be. Thus, a
state could choose the minimum rate applicable in all areas
of the state, the maximum rate effective anywhere in the sta
(the rate provided for in S. 983), or an average effective
rate somewhere between the two.

3. Provide for a de minimus rule at a higher threshhold than is provided in S. 983. S. 983 provides a $20,000 taxable sales during the previous year's threshold. The thresh
should be set at a level which ensures vendors selling into
jurisdictions with state and local rates would not be overly
burdened by the need to account for those rate variations.

Federal Administration

S. 983 is so broad in its scope, that its authors included provisions for partial Federal administration of its provisions. It is proposed that the U.S. Court of Claims be directed to review
de novo tax petitions on appeal from the state administrative appe
process. This is an unnecessary and undesirable proposal because:

1. State tax appeals processes in recent years have improved and modernized so that taxpayers more often receive a full and prompt opportunity to have their grievances redressed; and

2. The United States Supreme Court, in its recent decision in the Mobile Oil case, has pointed to the Supreme Court's power to identify and correct a discriminatory effect of a state tax law where multiple state taxation is involved.

Conclusion

Both S. 983 and S. 1688, as presently drafted, have significant revenue and policy impact on the State of New York and its local sales tax jurisdictions which make these bills costly and unacceptable. New York does not oppose reasonable Federal legislation to resolve interstate and international tax compliance problems and is willing to work with taxpayer groups and the Congress to reach equitable solutions. We have participated in this effort since the issues were first raised and have, through the National Association of Tax Administrators, participated in Senate Finance Committee staff sponsored discussions designed to identify and resolve the most difficult and pressing concerns. It appeared that considerable progress was made last Spring in that effort. We suggest that if further consideration is to be given these problems that a reopening of such discussions, or a similar forum, be considered. Such an effort, in connection with the study underway at the General Accounting Office on franchise and income tax problems, may be the best next step forward.

Before the Finance Subcommittee
on Taxation and Debt Management
U.S. Senate

HEARINGS ON S. 1688
June 24, 1980

STATEMENT ON BEHALF
OF THE
DUTCH EMPLOYERS' FEDERATION

(Federation of Netherlands Industry (VNO) and
Netherlands Federation of Christian
Employers (NCW): VNO/NCW)
(Raad van Nederlandse Werkgeversverbonden VNO en NCW)
(Verbond van Nederlandse Onderneimingen en
Nederlands Christelijk Werkgeversverbond)

presented by

Joseph H. Guttentag
Arnold & Porter
Washington, D.C.

This material is being submitted by the firm of Arnold & Porter, 1200 New Hampshire Avenue, N.W., Washington, D.C. 20036 on behalf of its client, Dutch Employers' Federation, the Hague, The Netherlands. Since the Dutch Employers' Federation is a foreign organization, Arnold & Porter is registered with the Department of Justice under the provisions of 22 U.S.C. § 611, et seq., as an agent of such foreign principal. Copies of this material are being filed with the Department of Justice, and copies of Arnold & Porter's registration statement are available for public inspection at the Department of Justice. Registration does not indicate approval of this material by the United States government.

Summary

The worldwide combination tax system imposed by certain states:

- -- is contrary to U.S. policy as enunciated in international agreements and organizations as well as to internationally accepted rules of income allocation;
- -- is violative of the Treaty of Friendship, Commerce and Navigation between the United States and the Kingdom of the Netherlands and the Double Tax Convention;
- -- has been criticized by the Government of the Netherlands and all of the Common Market countries;
- -- results in assessment of arbitrarily imposed state taxes;
- -- requires inordinate and undue recordkeeping burdens particularly on foreign based multinationals;
- -- results in double taxation.

Statement of Joseph H. Guttentag
Before the Finance Subcommittee on
Taxation and Debt Management
S. 1688

INTRODUCTION

This statement is submitted on behalf of the Dutch Employers' Federation (Federation of Netherlands Industry (VNO) and Netherlands Federation of Christian Employers (NCW)). The Dutch Federation, with its seat at The Hague, represents more than 10,000 enterprises and most of the various representative bodies and associations for specific industrial or commercial sectors in the Netherlands. We welcome this opportunity to present our views on the use of the worldwide combination method for determining state taxes in the United States and to submit evidence in support of S. 1688. Our views on this matter are supported by our entire membership.

STATEMENT

Scope of Netherlands Interests

1. The Netherlands, although a small country, is nevertheless the largest foreign direct investor in the United States. According to figures derived

from a survey published by the U.S. Department of Commerce, which appear as an annex to this statement, the total foreign investment in the United States at the end of 1978 amounted to $40.9 billion, of which the Netherlands accounted for $9.8 billion, or nearly 24%. Of the increase during 1978, totalling $6.2 billion, the Netherlands accounted for $1.9 billion, or about 31%. These figures show how involved the Netherlands is in international investment especially in the United States. Naturally, the tax climate in the United States is of great interest to our members.

2. Dutch business circles are gravely concerned about the problems of the worldwide combination tax method, which is presently applied by several of the states. When the present wide application of such method by the California Franchise Tax Board made itself felt around 1973, consultations between the Dutch Ministry of Finance and the Dutch industry were held to investigate the possibility of a complete negotiated solution to be reflected in a new tax convention with the Government of the United States. This plan, however, was suspended when it became known that the United Kingdom was already going to negotiate with the United States for similar protection. For us, this matter

has now become urgent again because of the decision of the U.S. Senate not to act on this issue via a clause in double taxation treaties.

U.S.-Netherlands Treaty of Friendship, Commerce and Navigation

3. Although a solution through a new treaty was not to be available, Netherlands companies doing business in the United States are entitled to the protections of The Treaty of Friendship, Commerce and Navigation between the United States of America and the Kingdom of the Netherlands, signed at The Hague, March 27, 1956, 8 U.S.T. 2043, T.I.A.S. No. 3942 (the FCN Treaty) and the Convention between the United States of America and the Kingdom of the Netherlands with Respect to Taxes on Income and Certain Other Taxes, signed at Washington, April 29, 1948, 6 U.S.T. 3696, T.I.A.S. No. 1855, as amended by the Supplementary Convention, signed at Washington, December 30, 1965, 17 U.S.T. 896, T.I.A.S. No. 6051 (the Tax Convention). These international agreements establish standards for taxation by federal and state authorities of Netherlands companies having business interests in the United States.

The FCN Treaty requires that state taxation meet general standards of reasonableness and

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nondiscrimination. State taxing authorities must "at all times accord fair and equitable treatment to the nationals and companies of the [Netherlands], and to their property, enterprises and other interests," Art. I, § 1, and are barred from taking "unreasonable or discriminatory measures that would impair the rights or interests" in the United States of Netherlands companies or their subsidiaries. Art. IV, § 3. Netherlands companies doing business in the United States may not be subjected "to the payment of taxes . . . or to requirements with respect to the levy and collection thereof, more burdensome than those borne" by companies of any third country. Art. XI, § 1. The Tax Convention provides that Netherlands companies and their subsidiaries may not be subject to "more burdensome taxes" than are United States companies. Art. XXV, § 4. Finally, the FCN Treaty prohibits United States taxing jurisdictions from imposing or applying any tax "on any income or basis in excess of that reasonably allocable or apportionable" to the taxing jurisdiction. Art. XI, § 4.

In substance the provisions of the FCN Treaty and the Tax Convention protect Netherlands companies from unfair and inequitable tax treatment of any kind, and more specifically from state taxation which imposes a disproportionate burden of payment or compliance upon Netherlands companies, or which purports to tax income of those companies not reasonably attributable to the taxing state. The taxes and other financial burdens imposed upon Netherlands companies by states employing the worldwide combination method all too frequently violate these protections.

In an international setting, the custom of states is persuasive evidence of the standard of reasonable conduct. The worldwide combination method of taxation is inconsistent with that employed by practically all other taxing jurisdictions and fails to take account of the prevailing practice of separate accounting through the use of the principle of arm's-length dealing. The overwhelming practice of foreign taxing jurisdictions (including the Netherlands), of the United States Government, and of the major industrial states in this country is to require separate tax accounting for the income of the enterprise maintained in a taxing jurisdiction. In the event of a determination that a multinational business has used transfers between controlled companies to reduce income attributable to the taxing jurisdiction, that income is subject to

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reallocation under guidelines designed to establish an arm's-length basis for the transactions. The "arm's-length" standard has been recognized as a fair and efficient means of apportioning the income derived from international transactions to the appropriate taxing jurisdiction, and has been endorsed in United States tax conventions, in the Model Double Taxation Convention on Income and on Capital of the Organization for Economic Co-operation and Development (OECD), in the United Nations Guidelines for Tax Treaties between Developed and Developing Countries, and in the tax laws of most foreign nations. The mode of international taxation adopted by California and a handful of other states -- apportionment of the income of "unitary" businesses -- has been consistently rejected by the international community and, until very recently, by California itself.

The Netherlands Government shares our position concerning these treaty obligations and has recently approached the Department of State with regard to the unfair treatment of certain American subsidiaries of one of our members by the California Franchise Tax Board.

We recognize that this is not the appropriate forum to seek redress for our well-grounded position that the application of the worldwide combination method

of state taxation to Netherlands' enterprises is not permitted because of the United States treaty obligation described above.

However, this *is* the appropriate time and forum to consider legislation which will enable the states of the United States to adopt a system of taxation consistent with tax policies enunciated in international agreements with the Netherlands and other countries.

International Opinion

4. The Dutch Federation would like to declare its full adherence to the arguments and views put forwar in Document No. 180/195, adopted by the Executive Board of the International Chamber of Commerce on September 26, 1979. In the Resolution contained in this document, it is stressed that the worldwide combination method "could easily become a most important threat to international trade." More recently, all nine members of the European Common Market joined in a *demarche* to the Department of State. Copies of the diplomatic note were delivered to the Chairman of this Subcommittee, other congressional leaders and appropriate members of the Executive. After reciting the litany of problems

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with worldwide combined reporting, including compliance costs, inequities, double taxation, inconsistency with internationally accepted rules and incompatibility with principles adopted by the OECD, the Common Market Members urged prompt enactment of corrective legislation such as is embodied in S. 1688.

Objections Against Application of the Worldwide Combination Method

5. Although we believe that the arguments against the international application of the worldwide combination method are well known, we will summarize them here from our point of view. The worldwide combination method produces an inequitable allocation of the results of foreign operations to the states. It results in double taxation. Its application, in addition, presents overwhelming practical difficulties of compliance for Netherlands parent companies, greater than the burdens faced by American companies under such state requirements.

Consideration of Principle

6. As a matter of principle, it seems inappropriate to measure business profits arising in a certain country with yardsticks applying under widely

different circumstances to companies or branches in other countries. Such a yardstick may be defensible in very specific cases and between adjacent countries -- for instance with regard to railroad companies -- but in all other cases the application of this method on an international scale may not only lead to a highly distorted picture of reality, but also to distorting the results of fair competition. For example, suppose a business enterprise operating in a state such as California has profits in a given year of $1 million. This enterprise may compete with a similar subsidiary of a foreign group, also earning $1 million. If the foreign profits of this group are on a substantially lower level, the Californian subsidiary would pay lower taxes on similar California profits than its California competitor without affiliates. On the other hand, the California tax rate on the subsidiary would be higher in the reverse case, which can easily happen during the start-up period of a business or during a period of low profits. In this respect, the combination method seems to have a countereffective result, because it would likely reduce the tax of highly profitable California subsidiaries, whereas subsidiaries with lower profits or losses are penalized. In the latter case double taxation is almost inevitable.

The Worldwide Combination Method Does Not Result in Equitable Apportionment and Does Result in Double Taxation

7. The fact that the worldwide combination method of taxation has been rejected by the international community would not of itself demonstrate that its use is unreasonable, if that formula could be relied upon fairly to apportion income between taxing jurisdictions. As applied to the operations of businesses operating around the world, however, such formula fails to meet that standard.

The combination method relies primarily on the ratio of total payroll, sales and property within the taxing jurisdiction to the worldwide payroll, sales and property of the business which has been determined to be unitary. This ratio is applied to the jurisdiction's estimate of total worldwide income to determine the amount of income attributable to the taxing jurisdiction. The formula thus assumes that the ratio of payroll, property and sales within the taxing state to worldwide payroll, property and sales is the same as, or approximately equal to, the ratio of taxing state attributable income to the worldwide income of the business. This assumption can only be correct, however, if each dollar of instate payroll, property or sales produces essentially the same amount of income as an identical amount of payroll, property or sales made overseas.

In fact, the amount of income earned for any given amount of property, payroll or sales varies sharply between the United States and foreign countries. High plant, labor and operating costs often severely affect the profitability of companies doing business in the United States. The formula also assumes incorrectly the application of reasonably similar tax rates worldwide. In certain industries particularly, tax rates are extraordinarily high and it is inappropriate to use before tax income which may be deceptively high. Moreover, political and economic risks of investment are substantially higher in foreign countries than they are in the United States. These higher risks of investment are reflected in higher rates of profitability in those countries. Because the worldwide combination formula assumes away the existence of these very real differences in profitability, it overstates "instate" income and leads to state taxation of foreign source profits, which bear no relation to any business risk incurred in the taxing state, as if they had been earned there.

The specific elements of the apportionment formula necessarily inflate the "instate" income of multinational companies doing business in the United States. For example, wage rates are much higher in the United States than in most foreign countries. In many industries these differences are so large that they are not counterbalanced by the higher productivity per worker in the United States. Lower wages contribute to the higher profitability of business operating abroad -- higher profitability which is ignored by the worldwide combination formula.

The inadequacies of the property, payroll and sales formula are exacerbated by the lack of a recognized standard for the calculation of the income against which the formula is to be applied. This problem is in part due to the great diversity of accounting conventions applied in foreign countries. In addition, since 1971, foreign currency values have floated freely and erratically in relation to the value of the dollar. Netherlands companies, like many other foreign based companies, report their income in terms of foreign currencies, including, inter alia, pounds and guilders. Translation of these results to dollars on a constant basis would require an extraordinarily complex adjustment formula. To our knowledge, the states which rely upon the unitary formula have thus far failed to devise any formula adequate to accomplish that translation. In the absence of such a formula, the worldwide combination method is inherently arbitrary as applied to worldwide multinational businesses.

In view of these problems, it is not surprising that the income allocated to the taxing state under the combination method frequently bears no reasonable relationship to the income of the Netherlands company derived from "instate" sources or, indeed, to the total income of the company. Perhaps the starkest example of this phenomenon is the case of Scallop Nuclear, Inc., a subsidiary of Shell Petroleum N.V. Scallop is a 50% partner in General Atomic Company of San Diego, which is engaged in the development of high temperature gas-cooled reactors, a business which is logically and functionally distinct from all the other business activities of the Royal Dutch/Shell companies. For the tax years 1973-76, Scallop Nuclear reported federal income tax losses totalling $273 million, all of which were due to the California operations of General Atomic. Losses required to be recorded for financial reporting purposes were substantially larger, yet auditors of the California Franchise Tax Board have recently announced their determination that Scallop Nuclear's portion of the worldwide combined income of the Royal Dutch/Shell companies for those tax years is $40 million, a spread of over $300 million between "California income" and the Federal tax loss. It is self-evident that this assessment is arbitrary, and bears no relationship to income reasonably attributable to California. It thus violates the FCN Treaty with the United states.

The unfairness of such assessments is heightened when one considers that in most cases the additional income which the combination formula purports to reach has already been taxed in its country of origin. The clearest example of that type of double taxation is the case of Mercurius, N.V., a Dutch company and a subsidiary of Container Corporation of America ("CCA"), which during the relevant period was a publicly held company. According to public data between 1964 and 1966, Mercurius reported to the Netherlands taxing authorities an average annual pretax income of $384,000, and paid taxes to the Netherlands on that amount. Subsequently, the California Franchise Tax Board declared that Mercurius was unitary with CCA. When the Board applied its property, payroll and sales formula to Mercurius, it determined that Mercurius had earned only $197,000 of Netherlands source income annually. California includes most of the remaining $187,000 of the annual income which Mercurius reported on its Netherlands return in its California tax base. During the years 1964-66, Mercurius' average Dutch tax liability was $191,000 -- 97% of the amount of Mercurius' income which California contends should have been apportioned to the Netherlands during those years. A clearer example of double taxation can scarcely be imagined.

In the face of distortions of this magnitude, it cannot be seriously contended that the worldwide combination method is being applied to Netherlands companies solely, or even principally, to recapture profits siphoned off to affiliated corporations. Nor can it be argued that such distortions are merely the result of an inevitable conflict between two equally accepted and equally valid approaches to the taxation of multinational business, for the virtually universal judgment of the international community is that the arm's-length principle provides a fairer and more practical means of correcting for misallocations of income and expense between affiliated companies.

Instead, such incidents suggest an effort on the part of certain state taxing authorities to tax for a second time income bearing no relationship to the taxing jurisdiction by the use of a method of taxation that is inherently arbitrary and out of step with recognised international standards. Again this is the precise type of conduct that the Treaty of Friendship, Commerce and Navigation forbids.

Practical Difficulties for Netherlands Parent Companies

8. There are many other practical objections to the combination method. In the first place, it is by no means clear how far the unitary principle extends within a group. Among our members there are cases where some eight different subgroups might be constructed. The parent company cannot reasonably be required to recalculate the worldwide profits on eight alternative bases under particular states' tax accounting rules, in order to be sure that eventually it has got the right figure. One must stagger at the possibility that more American states or other jurisdictions would follow this bad example. The problem is particularly acute for Dutch parent companies since the Netherlands has always taken a very liberal attitude for taxing foreign

operations and gives in most cases a full tax exemption for dividends received by Dutch parent companies from their foreign subsidiaries. This system avoids any necessity to recalculate for tax purposes the profits of those subsidiaries. For that reason, Dutch parent companies are not equipped to comply with requirements from the various states to submit such a recalculation. Not only do demands for calculations and recalculations in our view violate Dutch sovereignty, but it also seems clear that Dutch companies would be reluctant to make or increase investment in a state imposing such requirements.

The Need for Complying with Demands for Information

9. The combined reporting method would not only impose extraordinary burdens of compliance upon many Netherlands companies, but those burdens would be greater than those borne by American companies faced with similar state tax requirements. An American company with worldwide operations, it is true, has to translate the accounts of its foreign subsidiaries, maintained in accordance with local standards, into a form acceptable to state taxing authorities, but Netherlands companies with similar worldwide interests must translate the accounts of their local subsidiaries into the form

required for use in their home country and then once more into the form demanded by the taxing state. Similarly, while a United States company must convert foreign currencies into dollars, Netherlands companies must, after converting various foreign currencies into guilders, go through yet the further stage of converting guilders into dollars for the benefit of the state tax authorities. The conversion is further complicated by the fact that exchange rates have varied widely over past years. Netherlands companies would be called upon to engage in a highly complex process of recalculating their accounts for the period for which information is demanded by the Board. In the case of one of our members, the entire process would have to be repeated for over 900 companies located in more than 100 countries.

Currency conversion is not the only burden upon Netherlands companies under the worldwide combination method. For example, California has adopted the practice of calculating the worldwide income of Netherlands companies according to financial accounting standards. This practice grossly inflates the amount of income subject to taxation in California. In contrast, United States companies regularly report their unitary income in accord with United States tax accounting conventions, which generally produce much lower income figures. Yet to recalculate on a United States tax basis the worldwide income of several hundred affiliated companies in order to obtain a more accurate assessment of California income would require our members to construct at enormous cost an entirely new set of books solely to satisfy the requirements of a single taxing jurisdiction. One of our members faced with a California tax assessment has estimated that the cost of preparing such records would be more than the $2 million in additional tax assessed by California. These obligations are clearly more burdensome than those borne by United States companies and are not only inappropriate but are violative of provisions of the FCN Treaty and Tax Convention previusly discussed.

10. For all the aforementioned reasons the Dutch Employers' Federation welcomes any step to curb the application of the unitary tax method. The Federation still regrets that a proper solution through extension of the relevant tax conventions provisions to the states has been rejected by the U.S. Senate, because such a solution would have protected all treaty partners, including the United States itself from

internationally inappropriate taxation methods in the countries covered by the treaty network. Under the given circumstances, however, all other possible steps must be welcomed, whether on the level of the states themselves or on the federal level. In this respect, it is our view that the S. 1688 would protect all Dutch direct investors in the United States, would eliminate the distortions of fair competitive results and the problems of discrimination caused by the worldwide combination tax approach, and would relieve the flow of capital and investment between the Netherlands and the United States of America of the enormous practical obstacles and constraints posed by attempted extraterritorial application of state revenue legislation.

FOREIGN DIRECT INVESTMENT IN THE UNITED STATES

Four Largest Positions:	Foreign Direct Investment Position in the United States at year-end 1978 Billions of dollars	%	Addition to Fore Direct Investmen Position in the United States during 1978 Billions of dollars	%
Netherlands	9.8	23.9	1.9	31.
United Kingdom	7.4	18.1	1.0	15.
Canada	6.2	15.1	0.5	8.
Germany	3.2	7.8	0.7	10.
Other countries	14.3	35.1	2.1	34.
Total	40.9		6.2	

Source: Survey of current business, of the United States Department of Commerce.

STATEMENT
SUBMITTED BY:
JAMES W. McGRATH
ON BEHALF OF
R. J. REYNOLDS INDUSTRIES, INC.

R. J. Reynolds Industries, Inc., supports S. 983 and S. 1688 because the Company views these Bills as significant and positive steps toward greater uniformity, predictability, and fairness in the area of state taxation. If either of these Bills is enacted into law, the result would be beneficial both to business and to the states. This benefit would accrue because such passage would establish published uniform guidelines governing areas of state taxation which, up to this point in time, have been in a state of turmoil because of the many divergent views and interpretations presently employed in the administration and filing of state taxes.

Because of the inability of the states to unilaterally reach uniformity in the application of their tax schemes and because of the Supreme Court's deferral to the Congress in this area, as evidenced in its recent decisions (most notably the Mobil Oil Corporation and Moorman Manufacturing Company decisions), it is apparent that the time is right for the Senate to act by formulating and enacting a Bill such as S. 983 or S. 1688 into law.

It is also noted that enactment of either of these Bills would bring about greater conformity between the tax systems of the 50 states and the tax system of the Federal government, thus allowing the United States to better speak with one voice in matters of international relations as acknowledged by the United States Supreme Court in Japan Line, Ltd. v. County of Los Angeles.

The Committee should be mindful of the need for state tax uniformity during its review of S. 983 and S. 1688 because of the potential for foreign retaliation against United States' businesses if neither Bill is enacted and worldwide unitary, combined or consolidated reporting is allowed to continue. Many foreign countries with which the United States has substantial economic ties, notably Japan and the United Kingdom, have vocalized their strong objections to worldwide combined reporting. These nations expect action by the U. S. Congress to alleviate the hardship caused to their domestic companies by the unitary, combined or consolidated method of state taxation. If such relief is not forthcoming, it does not strain the imagination to conceive of these countries retaliating against American business by the enactment of comparable taxing provisions or the erection of other trade barriers thus compounding the damage already inherent in the worldwide unitary, combined or consolidated system as now applied by several states.

Both S. 983 and S. 1688 respond to and assist in the resolution of problems created by the use of worldwide unitary, combined or consolidated reporting and the taxation of foreign source income by effectively prohibiting the use of the worldwide unitary concept. However, other problems posed by the use of the unitary, combined or consolidated reporting concept as well as other state tax concepts are not addressed in S. 1688. It is the conviction of R. J. Reynolds Industries that S. 1688 should be viewed as an excellent first step in the resolution of the problems caused by these systems of taxation, but not as an all-encompassing cure to these problems. S. 983 addresses a broader spectrum of problems and is, therefore, viewed as the preferred legislation, although it too does not address all problems presently extant in this area.

A primary problem under present law is the arbitrary and unreasonable manner in which the determination of whether a business is unitary in nature is made. Two tests have been developed by the states for use in such determination. The first is the so-called "three unities test" which is used to determine whether a business is unitary by considering whether unity of ownership, unity of operations and unity of use exist among affiliates. A second test utilized in this determination is one of "interdependency," that is, whether interdependency exists between affiliated corporations in their various operations and functions. As you can readily see, these tests are inherently vague, subjective, and prone to manipulation. The lack of clear-cut objective guidelines or elements encourages the application of unitary, combined or consolidated reporting based on a motive of maximizing tax revenue rather than on any true attempt to determine whether a business is, in fact, a unitary business.

A related problem is the combining of affiliates which engage in totally separate and distinct business activities into a single taxable entity. This sort of combination across diverse lines of business leads to distortions because it effectively eliminates the recognition of differentials in the income-producing capacity and required capital investment which are inherently different for different business enterprises. Such combination allows a state in which two affiliated corporations conduct totally different lines of business, one of which is heavily invested in that state although marginally profitable and the other of which is minimally invested in that state but highly profitable, to effectively import income for tax purposes via unitary, combined or consolidated reporting from outside the state in order to build its revenue base.

It is noted that S. 983 does to some extent rectify this problem by specifically excluding certain corporations from combined or consolidated groups. However, such combination of affiliated corporations with diverse lines can still be accomplished by the states by combining corporations not excluded under S. 983.

A third problem not addressed by this Bill again centers around a lack of uniformity in the application of unitary, combined or consolidated reporting principles. This problem is that the states tend to employ unitary, combined or consolidated reporting when it is to their fiscal advantage to do so, but not to employ these concepts when such use would not be to their advantage. Because of this situation, corporate taxpayers can find themselves effectively taxed on the same income by more than one state because, in general, states tend to apply the reporting method which best serves their need to raise revenue.

A final problem which merits the concern and attention of Congress (but which does not relate to the issue of application of unitary principles) is the lack of uniformity presently evidenced by the states in the employment and weighting of factors in formulae used to apportion corporate income for tax purposes. Currently, some states employ a three-factor formula made up of property, payroll and receipts factors to apportion taxable income. Some states use a two-factor formula employing two of the previously stated factors, and some states use a single-factor formula, based solely on receipts, to apportion income. Additionally, a number of the states employing the three-factor formula will double-weight one or more of the factors in the formula. These permutations exist because the states find it necessary to add extra emphasis to factors which, because of the nature of the state's economy, have greater impact than the other factors and, therefore, provide greater revenue. For instance, a state with relatively little industrial development might double-weight its receipts factor while a state with heavy industrial development might double-weight its property and payroll factors or employ only these two factors in its formula because such adaptations apportion a greater amount of taxable income to the state. In light of the Supreme Court's decision in the Moorman Manufacturing Company case, it is incumb upon the Congress to address and rectify this situation by enacting legislation to finally bring about uniformity in this area.

This latter problem is fully addressed and corrected by S. 9 but it is not treated by S. 1688.

As previously stated, S. 983 is viewed as the more preferabl legislation because of its broader scope. Specifically, it is fe that Title III of S. 983 is extremely significant because of the contribution this Title makes toward establishing uniform standar for the application of net income taxes by the states.

This Title contributes to fairness in the administration of these taxes by affixing a ceiling on the amount of income which can be properly taxed by an individual state. This ceiling is determined by limiting the amount of income subject to taxation to the amount that such state could reach by using the standard three-factor formula to apportion income for tax purposes. The employment of this ceiling leads to uniform treatment of taxpayer by all states using formula apportionment and prevents the potent "whipsawing" of taxpayers by states using differing formulae in order to maximize revenues.

Additionally, by using the amount of income which can be apportioned to a state for tax purposes via a standard three-factor apportionment formula employing equally weighted property, payroll, and sales factors as a ceiling, the problem created in the past few years because of the use of differing apportionment formula factors and factor weighting by states would be corrected. This correction would occur because the states by being limited in their ability to apportion income for taxation to the amount apportionable via the standard three-factor formula would be effectively required to adopt such formula as their statutory apportionment method.

This Title is also desirable because it allows each state to determine the types of income which it can subject to a net income tax with the exception of dividends and foreign source income. Dividends are directly allocated if they are received by a taxpaying corporation which owns less than 50 percent of the voting stock of the paying corporation, or they are wholly excluded from taxation if received by a taxpaying corporation from a corporation in which it holds more than 50 percent of the voting stock. Foreign source income is wholly excluded from taxation.

Another facet of Title III of S. 983 which warrants favorable comment is the section concerning combined or consolidated reporting. This section clearly recognizes the corporate entity as the taxable entity. Recent developments in state tax law have created a trend toward the nonrecognition of the corporate entity, and the Bill's approach implements the reversal of this trend. Also, the exclusion of corporations of an affiliated group which derive 80 percent or more of their gross income from sources without the United States is highly desirable because it effectively eliminates the use of worldwide unitary combined reporting by the states. The elimination of worldwide unitary combined reporting is desirabl because of the many distortions and injustices inherent in that system of taxation.

Title I of S. 983 is considered desirable because it sets forth simple, reasonable jurisdictional standards which can be employed by businesses to determine whether they are required to collect and remit state sales and use taxes on sales made into individual states. These standards embodied in §101 of the Act, because they would be applicable in all states and political subdivisions of the states, would bring about the uniformity and predictability in this area in order to allow businesses to determine with certainty when such filings and remissions should be made.

In addition, by mandating a destination test to determine which state may impose its sales and use tax on a transaction the danger of multiple taxation of such transaction is virtually eliminated.

Further protection against multiple taxation is also provided by the Bill in that it requires states imposing a use tax upon property brought into the state to give credit for sales taxes paid on such property in the state of purchase. The lack of such requirement, presently existent in some jurisdictions, can lead to the payment of sales and use tax on more than 100 percent of the value of articles purchased.

Finally, this Title provides much needed protection for small businesses from the onerous administrative burden of collecting and remitting sales and use tax in states where such businesses' sales are minimal in nature. This feature is highly desirable because many small businesses previously did not attempt to transact business in states where sales would be relatively insignificant because of the administrative burden that would result due to the requirement of collecting and remitting the sales and use tax on transactions. These small businesses would now be free to enter these new markets and thus promote healthy competition with other businesses and provide a wider choice for consumers than was previously available.

Title II of S. 983 establishing guidelines governing the imposition of gross receipts taxes is likewise viewed as highly desirable because it, too, establishes a uniform jurisdictional standard to be observed by the states in imposing such taxes on interstate sales of tangible personal property. This standard requires that a business solicit such sales through a business office in the jurisdiction in order for that jurisdiction to impose its tax.

By prohibiting states from imposing a gross receipts tax on such sales unless they are solicited through a business office of the seller within a state or political subdivision in accordanc with §201, businesses will be able to predict with certainty where and to what extent their sales will be subject to gross receipts taxes. This obviously is highly preferable to the pres situation in which a business, in order to determine whether it has nexus with a state sufficient to allow the imposition of suc taxes, must interpret and apply a myriad of United States Suprem Court and state court cases to its operations in each state.

Finally, Title IV of S. 983 is applauded for establishing a system of appeal from determinations of state administrative bodi directly to the U. S. Court of Claims. This system promotes uniformity in the interpretation of the Act. By diverting such appeals from a course of review through the courts of the various states, the potential for diverse and contradictory interpretatio of the Act by these various state courts is avoided. This syste creates a method for the eventual building of a homogeneous body of judicial interpretation to give further guidance to taxpayers in interpreting the intent of S. 983.

S. 1688, by limiting the ability of the states to tax foreig source income, is a significant, positive step toward greater uniformity and predictability in the area of state corporate inco taxation, although such Bill, because of its limited scope, is considered less attractive than S. 983.

If S. 1688 is enacted into law, domestic and foreign parent corporations could be certain that income derived from and entirely attributable to foreign subsidiaries or parents would not be considered in the calculation of their domestic state income tax liabilities until repatriated, or deemed repatriated under uniform tax rules. This feature enhances uniformity and greatly lessens the difficulty of state tax planning by causing the treatment of foreign source income by the states to be more predictable.

CONCLUSION

In conclusion, R. J. Reynolds Industries, Inc., views S. 983 as the more preferable piece of legislation before the Committee because this Bill addresses and corrects a broader range of problems presently being experienced in the area of state taxation than does S. 1688. However, by making this statement, it is in no way implied that R. J. Reynolds Industries, Inc., does not fully support S. 1688. The enactment of either of these Bills into law would be of tremendous importance in expediting the creation of a more uniform state tax structure and the enactment of either of these Bills would indicate to the states the willingness of the Federal Government to enact legislation in order to gain equity and fairness in this area when the states have repeatedly failed to take such action themselves.

* * *

SUBMITTED STATEMENT OF THE AMERICAN FEDERATION OF LABOR & CONGRESS OF INDUSTRIAL ORGANIZATIONS TO THE SENATE COMMITTEE ON FINANCE, SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT ON MEASURES TO RESTRICT STATE TAXATION OF MULTINATIONAL CORPORATIONS

S. 983 and S. 1688

July 11, 1980

The AFL-CIO is opposed to S. 1688 and to the corresponding provisions of S. 983, which would place substantial limitations on the ability of the states to tax multinational corporations.

These bills are contrary to the interests of the U.S. economy, the states, and to working people generally. They would prohibit the states from using equitable and enforceable methods of taxing the income of multinational corporations, thus adding more tax avoidance opportunities to overseas operations and eroding the revenue base of the states.

Basically, these bills impose two restrictions on state taxing powers.

First, they would impair the ability of the states to distinguish a multinational corporation's foreign income, which they cannot tax, from its domestic income, which they can tax. Such distinctions are necessary to assure tax fairness, maintain state tax revenues and to blunt some of the tax avoidance opportunities available for businesses that invest and produce abroad.

Due to federal tax preferences, such as "deferral" and the foreign tax credit, U.S. companies have a strong incentive to use "creative" accounting methods to convert their U.S. earnings into what appears on paper to be "foreign income."

The federal government in its effort to prevent corporations from diverting income to their foreign affiliates -- essentially through intercompany transfer pricing gimmickry -- uses "arms length" rules hich attempt to assure that intercompany prices are the same as prices harged between unrelated companies. This arms-length method is based n fictions that the affiliates of multinational corporations are ndependent little businesses which deal with each other on an arms-ength basis, and, that the IRS can effectively enforce such standards o prevent corporations from diverting income and avoiding their fair hare of U.S. taxes.

Dissatisfied with the IRS procedures several states have developed n alternative to the arms-length method. Under this alternative -- he "unitary" approach -- the amount of income of a corporation doing usiness within the state that is subject to the state's income tax s prorated by a formula based on the total domestic and foreign income n the case of commonly owned and centrally controlled corporations. he states' method does not require arms-length pricing rules which re both elaborate and difficult to enforce. In our view, their pproach represents a much more effective and realistic procedure or determining and allocating income.

To bar this method, as these bills would do, would be to foreclose rogress in this important area of tax enforcement. The states should ot be relegated to outmoded and ineffective approaches which provide dditional advantages to U.S. overseas investment rather than domestic nvestment.

Secondly, S. 1688 and S. 983 would effectively ban the states from axing the dividends that multinational corporations receive from their verseas affiliates. This exemption from state taxation would apply, or example, to most of the dividends which the major oil companies eceive from ARAMCO, their Saudi Arabian affiliate. Again, an incentive or U.S. companies, including oil companies to produce overseas instead f the U.S. And, an incentive that is contrary to national policy of ecreased reliance upon imported oil.

For these reasons the AFL-CIO is opposed to S. 983 and S. 1688. We urge this Subcommittee and the Congress to turn attention to measures which would limit rather than expand the tax evasion and avoidance opportunities of multinational corporations.

CMA
CHEMICAL MANUFACTURERS ASSOCIATION

July 11, 1980

The Honorable Harry F. Byrd, Jr.
Chairman
Subcommittee on Taxation
and Debt Management Generally
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This statement is submitted on behalf of the Chemical Manufacturers Association (CMA) in connection with the hearings held by your Subcommittee with respect to S. 983 and S. 1688, which clarify, among other things, the extent to which a state, or political subdivision, may tax income from sources outside the United States.

CMA is a nonprofit trade association having 192 United States company members representing more than 90 percent of the production capacity of basic industrial chemicals within this country. Many of these company members derive income from sources outside the United States, either from branch operations or investments in subsidiary companies. Our members are, therefore, highly interested in seeing that their activities abroad are taxed on a fair and equitable basis by states and localities.

S. 983 is a comprehensive bill that prevents a state from imposing an income tax on the foreign source income of a multistate corporation, thereby giving recognition to the fact that there is at best only a tenuous relationship between the activity of a corporation within a state and the generation of foreign source income. In addition, the bill would go a long way toward preventing overlapping taxation of income by the states, as well as providing reasonable rules concerning state jurisdiction to impose gross receipts and sales and use taxes.

S. 1688 is of more limited scope. It would generally prohibit states from taking into account, in applying their income tax to a corporation, the income of a related foreign corporation except to the extent that such income may be included for Federal tax purposes under Subpart F in the gross income of the corporation subject to tax by the state. Additionally, dividends received by

Formerly Manufacturing Chemists Association—Serving the Chemical Industry Since 1872.
1825 Connecticut Avenue, NW • Washington, DC 20009 • Telephone 202/328-4200 • Telex 89617 (CMA WSH)

he taxpayer corporation from a foreign corporation would be educed by a formula to account for foreign taxes paid with espect to the dividend. In this manner, states could tax only hat portion of a foreign source dividend that is effectively axed by the Federal government after allowance of the foreign ax credit.

MA strongly supports S. 983 and urges its passage. The niform formula for allocating and apportioning the income of corporation among the states ensures that the same income ill not be taxed by more than one state. Equally important, ll foreign source income is excluded from apportionable income. MA also supports S. 1688, although it is a somewhat more limited easure than S. 983. The increased tendencies of states to tax n a unitary basis and to extend the application of the unitary oncept to worldwide operations requires Federal legislation to revent unfair and burdensome taxation. The elimination of the nitary concept is of primary importance, and both bills address his problem.

he unfairness of the unitary concept as applied on a worldwide asis particularly in states such as California has been well ocumented before this Subcommittee. We need only add that the hemical industry has also been faced with this unfairness. The rimary cause is the same: sale prices, payroll, profit margins nd property costs all differ drastically throughout the world, et the unitary concept assumes that all of these factors remain onstant. Even within the United States these factors vary idely, but the distortions that are produced by applying the actors worldwide are so great as to render the resulting income llocable to any one jurisdiction as an imprecise measure. And, he unitary formula results in overallocation to the high cost urisdiction.

ne example points up the fallacy of the unitary formula applied orldwide. Comparative per hour wage rates in dollars in 1976 ere $6.90 in the United States, $3.26 in Japan, and $.50 in ndonesia.*/ Any use of a payroll factor by a state taxing uthority that does not take these differences into account will esult in a substantial overallocation of income to the taxing tate. Margins in many developing countries will reflect the reater risks of doing business there, such as expropriations nd exchange controls. An additional inequity of the unitary oncept when applied to worldwide operations is the administrative

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/ International Economic Report of the President, January 1977, Figures 43, 44, pages 99, 101.

cost and difficulty of converting data into the various factors used by states to allocate income.

The unitary concept is contrary to traditional methods of allocating income between jurisdictions. Since the Revenue Act of 1928, the United States has followed a policy on the Federal level and in its many income tax treaties that a corporation foreign to a taxing jurisdiction should generally be subject to tax in that jurisdiction only on income derived from sources therein. An arm's-length dealing concept can be applied to ensure that the source of income rules are not abused. The source of income and arm's-length concepts are contained in many international treaties, including treaties of friendship and commerce. The 1977 model treaty of the Organization for Economic Cooperation and Development contains these concepts. This long development of techniques and procedures for equitably adjusting competing claims to the taxing of multi-jurisdictional entities should not be turned aside.

In conclusion, CMA believes that a corporation should pay income tax to states and localities on income fairly attributable to those jurisdictions. Both S. 983 and S. 1688 would provide a framework in which state taxation could be more fairly applied. S. 983, as the more comprehensive bill, goes further in assuring fair and equitable taxation by all states. We therefore favor its passage. S. 1688 is a less desirable bill because of its limited scope, but we would support it as an initial step toward solving the difficult problem of state taxation of multistate companies.

Sincerely,

Robert A. Roland
President

STATE OF
WASHINGTON

Dixy Lee Ray
Governor

DEPARTMENT OF REVENUE
Olympia, Washington 98504 MS-AX-02

June 17, 1980

Mr. Michael Stern, Staff Director
Committee on Finance
2227 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Mr. Stern:

We have learned that the Senate Finance Subcommittee on Taxation has scheduled a hearing for June 24, 1980, on S. 983 as well as S. 1688, both sponsored by Senator Mathias. This letter is intended as testimony to the Subcommittee of our views on the proposed bills.

S. 983 is the successor to S. 2173 (1977) on which we have previously presented strenuous objection (copy attached as Exhibit I) and S. 1688 is identical to H.R. 5076 which we and other states strongly oppose (see Exhibit II, attached).

As to S. 983, we see clearly that Title II thereof is aimed directly at the State of Washington because it would exempt General Motors and similarly situated multistate taxpayers from our business and occupation tax, which such taxpayers are now, and have been, paying. The amendment to S. 2173 which appears as Section 202 in S. 983, does not "put to rest the fears" of this state, as claimed by the sponsor. That section says we may continue to impose our gross receipts tax upon "activities occurring entirely within [Washington State]." We would think the Congress would not feel it needed to authorize a state to tax activities which "occur entirely" within that state. But the fact that this provision appears in S. 983 confirms and reinforces our belief that the purpose of the legislation is to give tax immunity and preferential treatment as to extensive and substantial business activities occurring in a state, so long as such activities are not entirely within a particular state.

We remain convinced that this is not a time when the Congress should be considering ways to constrict and restrict the tax base and legitimate taxing powers of the states. Instead, the Congress should be looking for ways for the states to more effectively and efficiently collect their taxes.

Sincerely,

Charles W. Hodde

Charles W. Hodde
Director

CWH:jj
cc: The Honorable Jimmy Carter
The Honorable Warren G. Magnuson
The Honorable Henry M. Jackson
The Honorable Charles Mc C. Mathias, Jr.

Exhibit 1

STATE OF
WASHINGTON

Dixy Lee Ray
Governor

DEPARTMENT OF REVENUE
Olympia, Washington 98504

December 18, 1978

The Honorable Charles McC. Mathias, Jr.
United States Senate
358 Russell Senate Office Building
Washington, D. C. 20510

Dear Senator Mathias:

On December 11 I received your notice of hearing in San Francisco on S. 2173 to be held December 20, 1978. I regret that I am unable to make arrangements for attendance at the hearing by a representative from the State of Washington at this late date.

However, because we have grave reservations with respect to this bill, I am sending the attached statement outlining our position on the proposal.

Sincerely,

Charles W. Hodde

Charles W. Hodde
Director

CWH:tl

attachment

cc: The Honorable James O. Eastland
The Honorable Warren G. Magnuson
The Honorable Henry M. Jackson
The Honorable Russell B. Long

STATEMENT OF POSITION
ON S. 2173
By

DEPARTMENT OF REVENUE, STATE OF WASHINGTON

Our reading of the proposal embodied in S. 2173 reveals that it contains some 30 provisions which would restrict and reduce the power of the states and their subdivisions to levy and collect taxes upon transactions, business activities, and income of multistate and multinational businesses. The bill seems designed to prevent the states and their subdivisions from requiring such businesses to pay their fair share of state and local taxes. We believe the bill is detrimental to the interests of the states, their subdivisions, and the great bulk of the business community which is not in a position to take advantage of the preferential treatment afforded by the bill's provisions.

It is clear that Title II of the bill is aimed directly at the State of Washington and would overturn the U.S. Supreme Court decisions in the General Motors and Standard Pressed Steel cases. Why General Motors and similarly situated multistate businesses should be exempt from paying their fair share of Washington taxes is not explained. General Motors is hardly a "small business" with only "ephemeral" contacts with the State of Washington, which is what we are told are the kinds of business the bill intends to protect.

It is no comfort to the State of Washington to be told that Title II only affects a few states and that there has been a tendency for states to replace gross receipts taxes with other revenue sources. Perhaps some in the Congress believe they know what sort of tax system is best for us. Our citizens believe otherwise.

Exhibit II

STATE OF
WASHINGTON
Dixy Lee Ray
Governor

DEPARTMENT OF REVENUE
Olympia, Wa. 98504

March 21, 1979

The Honorable Al Ullman
Chairman, Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Dear Representative Ullman:

We have received notice of the hearing which your committee will hold March 31, 1980, on H.R. 5076.

This letter is to express the strong opposition of the State of Washington to the bill. In our view it is special interest legislation which would give an unwarranted state tax shelter to multinational corporations and conglomerates. This would place purely domestic businesses at a competitive disadvantage, would discriminate against them, and would shift a heavier tax burden to them.

The states do not seek to tax more than their fair share of the income of multinational corporations. That fair share is best determined by apportioning income according to payroll, property, and sales within a given state to payroll, property, and sales everywhere. Multinational businesses should not be permitted to employ accounting gymnastics so as to artificially shift income elsewhere by characterizing it as foreign source income. The U. S. Senate to its credit was able to see the unfairness and inequity of this sort of scheme at the time of reserving Article 9(4) of the U.S.-U.K. Treaty in June 1978.

This is not a time when the U. S. Congress should be considering ways to constrict and restrict the tax base and legitimate taxing powers of the states. If the proposals for drastic reduction of federal grants to the states are carried out, the Congress should be doing the opposite: looking for ways for the states to more effectively and efficiently collect their own state taxes.

Since H.R. 5076 is identical to S. 1688 and may come up for consideration later, we are sending copies of this letter to our Senators Magnuson and Jackson.

Sincerely,

Charles W. Hodde

Charles W. Hodde
Director

CWH:jj

cc: The Honorable Jimmy Carter
The Honorable G. William Miller
The Honorable Warren G. Magnuson
The Honorable Henry M. Jackson

Mr. J. M. Haggar, founder of the Haggar Company, is unable to appear and he has asked me to make the following statement for him.

We are paying state taxes in the State of Washington and the State of West Virginia, which we originally had refused to pay because we thought they were unconstitutional. However, they tied up our accounts receivables and forced us to pay these taxes, which we are still doing. In checking with a lot of our competitors that have the same merchandise and the same kind of business, we are told that they do not pay these taxes. When we asked the states about this, they replied, "they will pay the taxes when we catch them." In my opinion, this is not the American way because it reflects inequities and unfairness.

We do not mind assuming this financial responsibility as long as the taxes are charged to all businesses in the same equitable fashion. The chaotic way these taxes are assessed, it not only is unfair, but precludes effective long-range business planning.

In my opinion, you and your committee should support bill #S-983 because it would appear that it is designed to correct a situation which goes against America's concept of fairness for all citizens and all businesses.

STATE TAXATION OF INCOME FROM BUSINESSES IN INTERSTATE COMMERCE:

IS THERE A NEED FOR FEDERAL LEGISLATION?

A memorandum prepared for
the General Accounting Office

Ferdinand P. Schoettle
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University of Minnesota
Minneapolis, Minnesota 55455
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I. INTRODUCTION

During the past two decades there have been numerous calls for federal legislation regulating the power of the states to tax the income of corporations engaged in interstate commerce. Many of the same parties who are represented at the General Accounting Office's conference testified at the recent hearings on H.R. 5076 before the House Committee on Ways and Means. Furthermore, many of us also participated in one way or another in Senator Mondale's 1973 Senate Finance Committee hearings.

Much of the discussion in previous calls for federal legislation has centered on the question of whether the laws of the several states were sufficiently uniform that a taxpayer could comply with the law without incurring substantial costs of compliance. The discussion of the past few years seems to me to differ in tone and substance from that of previous years: in testimony before the House Committee on Ways and Means the United States Treasury Department joined business in alleging that substantive rules of state taxation were having a chilling effect upon business investments. In this memorandum I would like to briefly address the question of whether the actual substantive law which has developed in the past decade, or so, is compatible with the federal government's interest in the free flow of commerce among the several states.

Even if one accepts the proposition that the law concerning the state taxation of corporations engaged in interstate commerce is becoming more uniform, one should still favor federal involvement through legislation, if one believes that the substantive law itself is not in the national interest.

The federal government should be principally concerned with the free flow of commerce among the several states and should not, in my opinion, attempt to enforce its notions of "fairness" on the states. The Constitution commits the nation to a free market economy in which the flow of investment capital and business among the several states should to the extent possible be unimpeded by any artificial barriers which might be created by state income tax statutes.

II. THE EFFECT OF STATE INCOME TAXES ON THE FREE FLOW OF COMMERCE BETWEEN THE STATES

The basic notion which traditionally guided the design of state income tax statutes which apply to foreign corporations has been to tax all income earned in a particular state. This is a straightforward enough notion and has some grounding in notions of fairness. However, more importantly, if a state taxes income which is not earned in that state the effect of such taxation is to reduce the post tax return from the business which is actually done in the state and to discourage investment in that state. Let me give an example. Suppose that a state's marginal tax rate is 8% and the federal marginal tax rate is 46%. State income taxes are deductible expenses in determining federal taxable income. If a corporation engaged in interstate commerce earns $100 in the state on which it pays taxes it will have a post tax income of $49.68. Suppose, however, that the corporation in addition to paying a tax on the $100 it has earned in the state also has to pay the state a tax on $100 which has not been earned in the state. In such a situation the corporation's post tax return will be lowered by $4.32 and the post tax income will be $45.36. In percentage terms the additional tax on the $100 on income not actually earned in the state has reduced the post tax return by 8.7%.

Now an 8.7% change in return on the face of it does not seem to be an impressive change. However, the federal investment tax credit is of a similar magnitude and is thought by many to affect corporate investment decisions. Furthermore, if one believes that the "extra" taxes in the above example will make no difference to corporate investment and business decisions one should also believe the converse, that is, that if corporations were relieved of the obligation to pay taxes in a state their investment and business in the state would not be altered in response to such favorable tax treatment.

The incidence of the "extra" taxes in the above model can be at least approximated using standard economic notions of tax incidence. The effects of such tax will differ depending upon:

(1) whether the tax is a uniform national tax on all income of all business;

(2) whether the businesses that pay the "extra" tax compete with other businesses that do not pay such tax, and

(3) whether the taxpayer's situation more closely approximates that of a monopolist or of a member of a competitive industry.1/

First, if the tax is a uniform national tax applying to all investments there will be no shifting of investments due to the tax because such shifting will not result in escaping the tax. Since state corporate income taxes are not uniform national taxes, it is fair to assess their impact using a model which allows investment decisions to respond to the imposition of a tax. Second, if the "extra" tax applies to an entire industry which does business in a state the tax may not in fact result in any very great change in investment decisions on the part of any particular taxpayer. The industry will reduce its supply and raise prices in order to keep its post tax return on invested capital intact. On the other hand, the taxpayer which competes with other businesses which do not pay the "extra" tax may not be able to affect the market price at which the taxpayer's goods are sold and should withdraw to other markets which provide a normal return on the taxpayer's investment. Finally, if the taxpayer which pays the extra tax is a monopolist rather than a competitor, the taxpayer should be able to use its market power to pass some of the tax along to the ultimate consumer.

One of the interesting points to emerge from reviewing the cases concerning the power of states to tax corporate income is that the law concerning state taxation has been developed largely in cases which concern companies with significant market power. As will appear in the discussion that follows it seems to me that the Supreme Court of the United States, the state courts, the Multistate Tax Commission, state commissioners of taxation, and counsel for taxpayers have by and large been inattentive to possible distortions in investment behavior which may be caused by the various substantive rules which are being developed concerning the power of the states to tax the income of interstate business. This lack of attention may well have occurred because the law in this area has been made in cases concerning such large companies -- mostly vertically integrated natural resource companies -- with such significant market power that notions concerning the possible "chilling" effects of state income taxes were not perceived as relevant to the particular case being litigated.

The balance of this paper will look in turn at the law concerning the apportionment of income, the unitary business doctrine, state jurisdiction to tax, and the standard of fairness which apportionment formulas must meet.

III. BUSINESS OR NONBUSINESS INCOME: ALLOCATION OR APPORTIONMENT

One of the critical areas of dispute about the power of the states to tax corporate income concerns whether certain income should be specifically allocated to a particular state or should be divided by formula apportionment among the states in which a taxpayer does business. In order to understand the origins of this dispute some background concerning the Uniform Division of Income for Tax Purposes Act needs to be reviewed.

The first draft of the Uniform Division of Income for Tax Purposes Act provided that "rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties" should be specifically allocated to particular states.[2] For reasons which are not now known to me these provisions of the first draft were changed during the floor discussions fo the committee of a whole of the National Conference of Commissioners on Uniform State Laws. What emerged from the floor discussion was the distinction now found in UDITPA concerning business and non-business income. In final form UDITPA provided that all "non-business" income should be specifically allocated and that "business" income should be apportioned according to the three-factor formula. The legislative history of UDITPA is surprisingly sparse. The only references in the literature which I have been able to find which speak to any reasons for this change seem to indicate that the reasons for the substantive change were to deal with some particular business situations which clearly should not be taxed by specific allocation. For instance, in the first draft rents from tangible property were specifically allocated to the state where the property was used in accordance with the extent of use or, if the taxpayer was not taxable in the state in which the property was used, to the taxpayer's principal income state.[3] Such rules of allocation would make little sense in the case of a manufacturer who engaged in equipment leasing. For instance, if goods were manufactured in state A and leased to users in state B, it might turn out that none of the income of the taxpayer was taxable in state A.

UDITPA as approved by the Commissioners on Uniform State Laws set forth that business income was:

> 'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Non-business income was defined as a residue: non-business income is "all income other than business income."

On its face the definition of business income is not particularly enlightening. Two sorts of business income seem to be contemplated. First, income from "transactions and activity in the regular course of the taxpayer's trade or business" are business income. On its face, this definition clearly includes income from mainstream commercial buying and selling in the taxpayer's trade or business. However, the definition raises as many questions as it answers. What is the taxpayer's "regular" course of business? Does this include all types of activity which are normally engaged in by the taxpayer, for instance, many corporate taxpayers will have portfolio income. Is such income in the regular course of business because it is usual or is such income not "regular" because the taxpayer's "regular" business is manufacturing and selling widgets. Second, the income from property is business income "if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." The second branch of the definition of business income may give somewhat more guidance to the definition of business income than does the first definition. The requirement that the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations at least suggests that the income from property will only be business income if integral to the taxpayer's "regular trade or business operations." The requirement that something be integral to business "operations" seems on its face a somewhat more particularized requirement than that the income arise in the regular "course" of business.

On its face the definition of business income seems to make sense only if it is construed as setting one test for income from "transactions" and "activity" and another test for income from "tangible and intangible property." Indeed, unless the statute contemplates a separate test for income from property the second branch of the definition of business income would never have to be invoked. Let us examine the example which apparently caused trouble with the first draft of UDITPA: the manufacturer who leases rather than sells the final product. First, such income from the lease would seem to arise in the regular course of the taxpayer's business. However, this fact alone may not be enough to make the income taxable. If we read the statute with care we can note that income arising in the regular course of the taxpayer's trade or business includes income from tangible and intangible property "if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Income from property apparently has to qualify as business income under the second part of the definition. For the case of the manufacturer with the equipment lease, the acquisition of the property would have risen as an integral part of the taxpayer's business operations: the taxpayer made it. Furthermore, the management of the property would also seem to be part of the taxpayer's regular course of business since the taxpayer would presumably provide spare parts and the like for both sold and leased property. Finally, the disposition of the leased property would be a sale of the very same property which the taxpayer manufacturers and would be thus integral to the taxpayer's business.

Let us turn now to see how the Multistate Tax Commission has interpreted the business income provisions of the statute.

The Multistate Tax Commission's regulations provide that "in essence, all income which arises from the conduct of trade or business operations of a taxpayer is business income."[4] Furthermore, income is business income "unless clearly classifiable as nonbusiness income." The regulations of the MTC make no distinction between income from property and other sorts of income since according to the MTC:

> The classification of income by the labels used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, nonoperating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business.[5]

By regulation the MTC has ruled the distinction between income from property and income from more normal sales activities out of the statute. In place of the discrete analysis which appears to be required by the statute the MTC has adopted the rule that "all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole" give rise to business income.[6]

Now, given the fact that the statute which the MTC has been charged with administering is not as clear as might be desired and given the important policy of not impeding the free flow of commerce within the United States, one could be sympathetic with a set of regulations which attempted to make sense out of the purposes underlying the business v. non-business distinction contained in UDITPA. If the literal application of the statute produced results which were at variance with the larger purposes underlying its adoption, regulations which followed the general intent of the statute might be preferable to those which followed its literal meaning.

Any statute which attempts to apportion income for purposes of taxation among the states should make as honest an effort as possible to allocate income to those states in which it is earned. As far as income from manufacturing and selling is concerned, any set of rules apportioning such income to various states will of necessity be somewhat arbitrary. If goods are manufactured in state A, placed in a warehouse in state B, sold by a salesperson in state C to a customer in state D and then diverted by the customer while in transit from state D to state E, no amount of metaphysical reasoning is going to provide an unambiguous answer to the question of where the income generated by the sale should be taxed. One can only hope to devise a set of rules which provide a satisfactory answer in the large majority of cases.

On the other hand, income from property can often be more clearly located than can other sorts of income. If the property is rented, the income from the property can be attributed to the state where the property is located. Income from dividends, presumably should be allocated to the state or states where the corporation paying the dividends earned the money from which the dividends were payed, and this actually was the approach taken by the first draft of UDITPA. The first draft provided that dividends should be allocated to the state of the payer except where the dividends did not originate in any state or when the taxpayer was not taxable in the state in which the dividends originated.[7] UDITPA as approved by the Commissioners on Uniform State Laws allocated dividends to the state of the taxpayer's commercial domicile.

The regulations of UDITPA concerning the appropriate disposition of income from property seem subject to serious question. First, they do not seem faithful to either the wording of the statute or to its legislative history. The first draft of UDITPA made a clear distinction between income from property and other sorts of income: all income from property was to be specifically allocated to particular states. UDITPA as finally approved contains language in the definition of business income which apparently continues this distinction. Furthermore, although not as specific as might be wished, Professor Pierce's comments on the Uniform Act seem to assume that income from intangibles is allocated to particular states, not apportioned.[8] Additionally, there is nothing in the legislative history of UDITPA to lead one to believe it was intended to make major changes in existing rules of allocation. The general rule in the 1950's was that income from property was taxed at the situs of the property.[9] Second, the designation of income from property as business income to be apportioned among the states gives rise to situations in which the states are permitted to tax income which has not been earned in the state.

Since the taxation of dividends seems the most important class of income from property which is currently denominated "business income" by the MTC, let us now turn to that subject.

Suppose that a corporation which manufactures and sells widgets also has a subsidiary which manufactures and sells widgets. Suppose further that both corporations are successful and that the subsidiary regularly returns its earnings as dividends to the parent. According to the regulations of the MTC in such circumstances the dividends from the parent to the subsidiary would be denominated business income and apportioned to the states in which the parent did business in accordance with the parent's factors. A number of problems arise from this treatment of the dividends as "business income." First, if the subsidiary has paid state income taxes the effect of taxing the dividends is to doubly tax corporate earnings. Such earnings would be taxed once when earned by the subsidiary corporation and taxed again as business income when returned to the parent. As things now stand states of traditional corporate domicile have -- probably as a price of retaining their traditional role -- recognized the problem of the double taxation of dividends and by and large exempt such dividends from a tax. On the other hand, states not of corporate domicile do not have the same incentive to avoid double taxation and may be pleased to tax the dividend income of foreign corporations. Some states, such as Wisconsin, have adopted a middle ground: in Wisconsin dividends will not be doubly taxed if the subsidiary's income has been taxed by Wisconsin but will be taxed if the income of the subsidiary was largely earned in other states. In any event, the practical effect of denominating dividends as business income is to increase the instances of the double taxation of corporate earnings at the corporate level.

Second, the allocation of dividends income according to the domestic factors of the parent has the effect of altering investment choices. If the parent corporation decides to do business in a UDITPA state or to increase its investment in the state it must pay a tax on earnings from the new business or investment as well as from the apportioned part of the dividends received from the subsidiary. On the other hand, another taxpayer who did not have the dividend income from the subsidiary would pay taxes only on the income actually earned in the state. By taxing dividend income in accordance with the three factor formula as applied to the parent's property, payrole and sales, the UDITPA states, if they follow the lead of the MTC, will be taxing income which has not been earned in the state.

IV. BUSINESS v. NON-BUSINESS INCOME IN THE COURTS

Those courts which have considered the distinction between business and non-business income have followed the MTC's lead in ignoring the statutory distinction between income from property and other sorts of income.[10] As far as I can tell from preliminary research, which is to be sure still incomplete, eleven states have approached the question of whether income from property is business income by asking the question whether the income arose in the regular course of the taxpayer's business. None of these state courts ask the questions suggested by the second branch of the definition of business income of whether the "acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Since some of these cases would have been decided the same way even if the particular court had taken a harder look at the statute which it was asked to apply, I am not suggesting that all of the cases which have followed the MTC's approach to business income were incorrectly decided.

The decision of the Supreme Court of Kentucky in Square D Co. v. Kentucky Board of Tax Appeals,[11/] while not based on nice distinctions contained in the definition of business income, at least addresses the question of whether the dividend income received by a corporation taxable in Kentucky could be said to have been earned in Kentucky. The court did not take the opportunity to adopt the approach of whether the dividends arose in the ordinary course of the taxpayer's business.

The New Mexico Court of Appeals recognizes that the definition of business income contained in UDITPA distinguishes between income arising in the regular course of a taxpayer's trade or business and situations where the acquisition, management and disposition of property constitute integral parts of the taxpayer's regular trade or business. However, the court has not yet focused on the fact that the statute distinguishes between income from property and other sorts of income. Indeed, the latest opinion from the New Mexico Court of Appeals seems to adopt the MTC's approach to the definition of business income.[12/]

My reading of the cases decided under UDITPA gives substantial support to the MTC's claim that it has promoted uniformity in the application of state tax statutes to corporate income. The MTC's approach to the definition of business income has been accepted and applied by most of the states which have considered the question of defining business income. To be sure, some states have not accepted the MTC's very expensive definition of business income. However, no state has yet construed the statute in accordance with its literal meaning. On the other hand the substantive law which has developed seems to me to pose substantial threats to the free flow of commerce within the United States. Let us turn now from the interpretation of the definition of "business income" to an analysis of some of the results reached under the MTC's approach to defining business income.

In American Smelting and Refining Company v. Idaho State Tax Commission,13/ the Supreme Court of Idaho held that the dividends received by ASARCO from M.I.M. Holdings, Ltd., a corporation doing business in Australia, in which ASARCO held a 52.7% stock interest were taxable business income to be taxed by Idaho in accordance with a three factor formula which made no effort to assign any of the dividend income to Australia. In holding that a portion of such dividends were taxable by Idaho the court pointed out that it recognized "that M.I.M. for the years in question, seems to have operated independently of ASARCO and did little if any business with ASARCO."14/ Furthermore, because of strong nationalistic feeling in Australia ASARCO had not voted its stock for directors of M.I.M. but had allowed the other shareholders, presumably Australians, to select the board of directors of the company. I see no way that the income from the capital invested in M.I.M. can reasonably be said to have been earned in Idaho.

In a recent case involving, among other things, income from foreign subsidiaries the MTC has pursued its effort to have dividend income considered as business income to be apportion among the MTC states. In Caterpillar Tractor Co. v. Lenckos[15] the Illinois Supreme Court considered the question of the proper treatment of the earnings of subsidiary corporations of Caterpillar Tractor doing business in foreign countries. UDITPA contains no definition of taxable income. Illinois like some other states has keyed its definition of taxable income to the definition of taxable income for federal tax purposes contained in the Internal Revenue Code of 1954.[16] Under the Internal Revenue Code of 1954 in order not to give tax preference to investments abroad the general scheme for income earned in a foreign country is that both the post tax income earned in the foreign country and the taxes paid in the foreign country are treated as taxable income for purposes of the federal corporate income tax. The basic idea behind the federal scheme is that income earned in foreign countries should be taxed at the same rate as income earned in the United States. To accomplish this purpose the Internal Revenue Code provides that the foreign source income will be taxed at the usual rate for the corporate income tax and thus, as set forth above, requires that both the taxes paid and the post tax income be reported as income for federal tax purposes. The Code then goes on to provide that the taxes paid to the foreign government can be a credit for federal income tax purposes. The Illinois Supreme Court held that this "income" from foreign sources was "business income" and was properly to be taxed by Illinois in accordance with the domestic factors of the Caterpillar Tractor Company. Again, I see no reasonable grounds on which the income earned by Caterpillar Tractor in foreign countries can properly be apportioned to Illinois on the ground that such income was "earned" in Illinois.

With respect to income from capital gains, rents, and royalties a number of recent cases have followed the MTC's approach and have taxed such income as "business income" arising in the ordinary course of the taxpayer's business. Because the court need only find that the income in question arose in the ordinary course of business and need not make any further finding that the income from capital gains, rents, or royalties could reasonably be said to have been earned at least in part in the taxing state, some of these cases might have come out the same way if decided under a different standard. An example of the application of UDITPA is Atlantic Richfield v. State of Colorado,[17/] a case in which the MTC appeared as amicus curiae. In an effort to secure approval by the federal government to its merger with Sinclair Oil Company the taxpayer, Atlantic Richfield Company, sold certain properties in the northeastern and southeastern United States to British Petroleum. None of the properties sold were located in Colorado. The Supreme Court of Colorado based its holding that the capital gains from the sale should be business income taxable by Colorado as apportioned on the ground that such gains "resulted from a transaction in the regular course of Richfield's business." Because the court so found it concluded that it "need not decide whether the second clause of the statute [the definition of business income] establishes a functional test to be applied to this income."[18/]

The ordinary-course-of-business test when applied to income from property does not answer the question whether the income from the property was earned in the state which is attempting to tax that income. I do not know whether Colorado was justified in taxing the capital gain income in Atlantic Richfield v. State of Colorado. Had the court applied the definition of business income set forth in the statute it would at least have been required to find that under the statute the "acquisition, management, and disposition of the property" constituted "integral parts of the taxpayer's regular trade or business operations." The most troublesome part of the definition from the point of view of Colorado's taxing the gains from real property located in another state would have been to find that the "disposition" of such properties was an integral part of the taxpayer's "regular trade or business operation."

As a normative matter, the course of judicial decision under UDITPA seems to be to tax "business income" which does not have that clear a relationship to the state which is seeking to impose the tax. The tax upon income not earned in the state assumes its clearest expression in the taxation of dividends and it is the taxation of dividends which seems to me to pose the most serious threat to the free flow of commerce between the states. To be sure, the application of the MTC approach to dividend income may not have that much effect upon the business decisions of large integrated oil companies with significant market power. However, for other taxpayers with less market power the rules of law which have been, and are being, developed seem to pose a significant threat to interstate business.

THE UNITARY BUSINESS DOCTRINE

The unitary business doctrine provides that in appropriate circumstances a "unitary business" should report its income for apportionment without regard to how the business is organized. Under the doctrine a division of a taxpayer can separately report its income to a state as a unitary business or alternatively a number of corporations which are commonly owned may be combined as a unitary business.

The unitary business doctrine if improperly applied can have the effect of taxing income not actually earned in a state. The basic notion that if a company is an integrated economic unit it should not pay less tax makes sense. However, on the other hand, the three factor formula which is applied to apportion income may in fact distort income. Let me give an example.

The doctrine has recently been applied to a number of vertically-integrated natural resource companies.[19] This application may in fact tax income not earned in the state. For instance, vertically integrated oil companies probably do make more money in today's markets from owning oil than they do from owning gas stations. It is not a closely held secret that the owners of oil are rich and that in recent years many gas stations have either been closed or have gone on restricted hours. If an oil company, which does retail business in a state, claims that it is making relatively little money on account of its retail operations, the allegation may well be true. On the other hand, ten or fifteen years ago the accounting situation was probably the opposite: the expensing of various costs of exploration meant that the oil companies probably showed more income from selling gas than they did from finding it and owning it.[20]

There seems to be no set answer to the question of when the unitary business doctrine should be applied.[21] However, there do seem to me to be situations where the application of the doctrine will in fact distort the income which is to be apportioned to a particular state.

As an economic matter, if tax rates were uniform and if all states in which the taxpayer did business used the unitary business doctrine to tax the taxpayer's income, there would in fact be no distortions. For every "extra" dollar which was taxed in a state in which it was not earned, a dollar would not be taxed in a state in which it was in fact earned. Thus the taxation of "extra" income since it was accompanied with under taxation in some other state would result in no burden to interstate commerce.

On the other hand, if application of the unitary business doctrine resulted in paying an "extra" tax on income not earned in the taxing state and if there were no compensating adjustmen in some other state, the use of the unitary business doctrine would be a deterrent to investment. The arguments against the application of the unitary business doctrine to foreign source income seem to me to raise the specter of a tax by a state on income not earned in the state which tax is not mitigated by any dimunition of taxes in the state in which the income was in fact earned. Treasury's Donald Lubick gave an example at the hearings on H.R. 5076 of a case where the application of the unitary business doctrine appeared to tax extraterritorial income without any compensating tax reductions in the states where the income was actually earned. According to my recollection of Lubick's testimony, a Hong Kong bank established a banking operation in California which had income in the particular taxable year of about $76,000. California applied the unitary business doctrine, used a world-wide three factor formula, which picked up substantial income from other sources, and, according to Lubick's testimony, levied a tax which was in excess of the earnings in California. As I remember the denouement, the California branch was closed. Thus the application of the unitary business doctrine can in some cases where income outside the United States is involved result in an extra tax burden because of the choice of doing business in a state.

As far as UDITPA is concerned the provisions which permit application of the unitary business doctrine seem far from unambiguous. The following propositions seem to me correct:

1. UDITPA on its face gives no specific authority for application of the unitary business doctrine.[22]
2. The only apparent authority for the application of the unitary business doctrine is Article IV § 18 of the Multistate Tax Compact, the so-called equitable adjustment provision.
3. Article IV § 18 required an affirmative finding that the normal methods of reporting income fail to adequately represent the business activity within the state.[23]

The regulations of the MTC may be more expansive than the statute permits. The current regulations require no finding that the income as reported by the taxpayer "not fairly represent the business activity of the taxpayer in the state."[24] In a rece major test case in Illinois concerning the application of the unitary business doctrine, *Caterpillar Tractor Co. v. Lenckos*,[25] the Appellate Court of Illinois upheld the position of the MTC concerning application of the unitary business doctrine. However, the opinion contains such a brief analysis of the applicable law that it is not a strong precedent.

Income earned outside of the United States occupies an anomolous position. One of the major effects of state corporate income taxes may be to encourage investment in countries which have lower tax rates than the United States. The federal government has attempted to mitigate this obvious incentive to invest abroad by eliminating some of the tax haven aspects of foreign investment. However, there is no accommodating state policy and any state policy of taxing income earned abroad faces difficult problems. First, if a state which is not a domiciliary state taxes income which is not earned in the state there is an obvious disincentive to investment in such state. On the other hand, the state of corporate domicile may well be dissuaded from taxing such income due to the ability of corporations to change their domicile. From a national perspective the federal government could either prohibit the states from taxing foreign source income or could grant a tax credit to corporations for that portion of their tax which was paid on account of foreign source income. Either policy would both remove impediments to investment in the states and solve the tax haven problem.

VI. JURISDICTION TO TAX: "SOLICITATION" UNDER P.L. 86-272

Attached to this memorandum is a copy of a paper prepared by a third-year law student at the University of Minnesota, Jerome Kahnke. As Mr. Kahnke's paper reveals there is no substantial agreement among the states concerning the meaning of P.L. 86-272.

P.L. 86-272 provides in pertinent part that a state shall not be permitted to tax income derived from within a state if the only business activities within the state are the "solicitation of orders . . . which orders are sent outside the State for approval or rejection and, if approved, are filled by shipment or delivery from a point outside the State."

As Mr. Kanhke's paper points out, to date eleven states have construed the protections against state taxation afforded by P.L. 86-272. The polar extremes of interpretation are Oregon and Pennsylvania. According to the Supreme Court of Oregon:

> '[S]olicitation' should be limited to those generally accepted or customary acts in the industry which lead to the placing of orders, not those which follow as a natural result of the transaction, such as collections, servicing complaints, [and] technical assistance and training.[26]

The Supreme Court of Oregon's construction gives the protection afforded by Congress under P.L. 86-272 the narrowest possible construction. On the other hand, the Supreme Court of Pennsylvania has given the statute a broader, and in my way of thinking a more sensible interpretation. According to the Supreme Court of Pennsylvania:

> The import of these decisions is that "solicitation" does not stop at the moment a prospective customer (or wholesaler) is asked to consider purchasing the seller's goods: other practices incident

> to the initial contact between buyer and seller, such as advice on making the product attractive to the ultimate consumer, also fall under the rubric "solicitation."[277]

Whatever one may think of the substantive issues involved in interpreting P.L. 86-272, the law seems neither uniform nor workable. Suppose, for instance, that a lawyer who represents a client desiring to acquire a corporation is asked to write an opinion letter setting forth the to-be-acquired corporation' potential liabilities for state income taxes. If income tax returns have not actually been filed in all states in which sales had been made, the lawyer in many instances would, in my opinion, have to inform the client that under the Oregon definit of solicitation the corporation to-be-acquired faced potential income tax liability plus appropriate penalties and interest in all states in which the corporation had made sales but had not filed a return. Under the Oregon test of solicitation the facts necessary to determine taxability may not be readily avail either to the lawyer who represents the potential acquirer or, indeed, to the to-be-acquired corporation itself. The corporatio may well have instructed its employees to do no more than solicit orders. However, the salesperson, who is anxious to keep an account, may well have performed services which would subject the corporation to income tax liability under the Oregon test.

An objective test which was framed in terms of the volume of sales would be preferable to the current standard. The law should provide that a certain dollar volume of sales in a particu state subjected the seller to that state's jurisdiction for purposes of a state income tax.

VII. CONSTITUTIONAL PROTECTION AGAINST IMPEDIMENTS TO THE FREE FLOW OF COMMERCE WITHIN THE STATES

As the above analysis has attempted to indicate the essential protection which should be accorded to business in interstate commerce is the protection against barriers to investment in nondomiciliary states. As far as the income tax is concerned there is a barrier whenever a state is able to tax income earned in a state by an interstate business at a higher "effective tax rate" than is visited upon other businesses within the state. The requirement that an interstate business pay a higher "effective tax" means that the interstate business earns a lower return on invested capital than local companies. Furthermore, if investments are available which permit the interstate business to invest elsewhere and earn a normal return on invested capital the effect of taxing income not earned in the state will be to cause the interstate business to withdraw from the state. The reason I have placed quotations around "extra tax" is that one need both consider the additional tax paid to the state which taxes income not earned within its borders and the tax saving, if any, realized in other states which may have accommodating statutes releasing the "extra" income to the taxing state. Only if the next effect is an extra tax will there be an impediment to investment in a state which taxes income not earned within its borders. It is this notion of a tax saving in another state which gives credence to the oft repeated shiboleth that a uniform system of taxation will not result in excessive burdens on interstate commerce.

The present Supreme Court has yet to focus its attention upon the effects of income and other taxes upon investment and business decisions but has instead tended to focus on the subsidiar and sometimes irrelevant question of whether a taxpayer has in fact been subjected to double taxation. In Japan Line Ltd. v. County of Los Angeles the Supreme Court granted the taxpayer relief on the ground that the taxpayer should be protected against double taxation.[28/] As a practical matter the tax under dispute in Japan Line offered no disincentive to doing business in Califor On the other hand, in cases in which there is no double taxation but where a substantial disincentive to investment is present the court has focused too much on the possibility of double taxation, without addressing the more important question of whether the rule of taxation being attacked will have a chilling effect on interstate commerce. In particular, the opinion of the Court in Mobil Oil Corporation v. Commissioner of Taxes of Vermont, seems to me poorly founded.[29/]

In Japan Line the Court was presented with a challenged California tax on cargo containers. As the Supreme Court understoo the problem it was that Japan placed a tax on the cargo containers of its domiciliary corporations, which the Court was powerless to apportion. California also placed a fairly apportioned tax on the cargo containers in accordance with the extent of their use in California. The Court, granted relief to the taxpayers, among other reasons, to avoid double taxation. This is not the place to review previous decisions upon which the Court relied. However, as a matter of tax incidence Japan's tax was the equivalent of a fixed cost on the ownership of the cargo containers and would have no effect upon business decisions since the tax was apparently to be paid no matter where the containers were used. California's tax on the other hand was fairly apportioned and merely imposed the same costs upon Japanese who competed in California's market as was imposed on others who offered the same services. Since the tax at issue would not in fact have a chilling effect upon interstate commerce there was no compelling reason to grant protection under the Commerce Clause.

On the other hand, in Mobile Oil Corporation v. Commissioner of Taxes of Vermont the Supreme Court considered the constitutionality of Vermont's taxation of the dividends received by the Mobile Oil Corporation. Since these dividends were not taxed in New York, the state of commercial domicile, there was no double taxation. According to the Vermont statutory scheme , corporate income including the dividends received by corporations which were doing business in Vermont were to be taxed according to an apportionment formula which represented "the arithmetic average of the ratios of sales, payroll, and property values within Vermont to those of the corporation as a whole."[30/] The apportionment formula used by Vermont made no effort to attribute any of the income earned by foreign subsidiaries to the places where those subsidiaries had actually earned the income but focused solely upon the fact that the income had been earned by Mobile which was admittedly doing business in Vermont.

Rather than focusing upon the question of whether the dividend income which Vermont sought to tax had been earned in Vermont the court placed its emphasis upon the threat of double taxation should New York, the state of commercial domicile, choose to tax Mobile's dividend income.

For reasons that are not apparent to me neither the Court nor counsel focused on the economic effects of taxing income not earned in a state. Much of the argument concerning the taxation of extraterritorial values centered around due process restrictions on the states' power to tax income not earned within the state rather than upon the chilling effects on interstate investment of taxing income not earned from business done in the state. The Court upheld Vermont's statutory scheme.

The Court limited its inquiry,

> to the question whether there is something about the character of income earned from investments in affiliates and subsidiaries operating abroad that precludes, as a constitutional matter, state taxation of that income by the apportionment method.[11]

The Court should have concluded that requiring those engaged in interstate commerce to pay a tax not only on the income earned within the taxing state but also on income earned from investments abroad posed an unconstitutional barrier to the free flow of commerce among the several states.

FOOTNOTES

See, R.A. Musgrave & P.B. Musgrave, *Public Finance in Theory and Practice* 396 et seq. (1973).

The first draft of what became UDITPA may be found as an appendix to Lynn, "Formula Apportionment of Corporate Income for State Tax Purposes: Natura Non Facit Saltum," 18 Ohio St. L. J. 84, 100 (1975).

Peters, "The Distinction Between Business and Nonbusiness Income," 1973 Univ. Southern Cal. Tax Instit. 251, 273; "State Tax News," Taxes 533, 534 (1958).

The current regulations of the Multistate Tax Commission are reprinted in Prentice Hall, *State and Local Taxes* (All states unit) Para 632-640 (1977). The current regulations were adopted in 1973 and contain a somewhat less expansive definition of business income than the first regulations promulgated by the MTC.

Id.

Id.

Lynn *supra* fn. 2 at 101-02.

Pierce, "The Uniform Division of Income for State Tax Purposes," 35 Taxes 747 (1957).

See, *American Smelting and Refining Co. v. Idaho State Tax Commission*, 592 P.2d 39, 46-47 (1979).

Stan Musial & Biggie's, Inc. v. State Dept. of Revenue, 363 So. 2d 375 (Fla. App. 1978); *Atlantic Richfield Co. v. State*, 601 P.2d 628 (Colo. 1979); *F.W. Woolworth Co. v.*

Commissioner of Taxes, 298 A.2d 839, 130 Vt. 544 (1972). *Champion Intern. Corp. v. Bureau of Rev.*, 540 P.2d 1300, 88 N.M. 411 (N.M. App. 1975); *Qualls v. Montgomery Ward & Co., Inc.* 585 S.W.2d 18 (Ark. 1979); *Texaco, Inc. v. Wasson*, 237 S.E.2d 75 (S.C. 1977); *F.W. Woolworth Co. v. Commissioner of Taxes of State*, 328 A.2d 402, 133 Vt. 93 (1974); *Atlantic Richfield Co. v. State*, 601 P.2d 628 (Colo. 1979); *Sperry and Hutchinson v. Department of Revenue*, 527 P.2d 729 (Or. 1947); *Western Natural Gas Co. v. McDonald*, 446 P.2d 781, 202 Kan. 98 (1968). Montana and Idaho have been somewhat more circumspect than some of the other states in adopting the MTC definition of business income. *Montana Dept. of Revenue v. ASARCO*, 567 P.2d 901 (Mont. 1977); *ASARCO v. Idaho State Tax Comm.*, 592 P.2d 39 (Idaho 1979).

11. *Square D Co. v. Kentucky Bd. of Tax Appeals*, 415 S.W.2d 594 (Ky. 1967).

12. Compare *Champion Intern. Corp. v. Bureau of RE.*, 540 P.2d 1300, 88 N.M. 411 (N.M. App. 1975) with *McVean & Barlow, Inc. v. New Mexico Bureau of Revenue*, 543 P.2d 489, 88 N.M. 521 certiorari denied 546 P.2d 71, 89 N.M. (N.M. App. 1975); *Tiperary Corp. v. New Mexico Bureau of Revenue*, 595 P.2d 1212, certiorari denied 593 P.2d 1078, 92 N.M. 675. (N.M.App. 1979).

13. *Atlantic Richfield Co. v. State*, 601 P.2d 628 (Colo. 1979).

14. *Id.* at 50.

15. 395 N.E.2d 1167 (Ill. App. 1979).

6. Illinois and Vermont seem to tax Subpart F income; In re Goodyear Tire & Rubber Co, 335 A.2d 310 (Vt. 1975); F.W. Woolworth Co. v. Commissioner of Taxes, 298 A.2d 839, 130 Vt. 544 (Vt. 1972); while Massachusetts and Pennsylvania do not. Dow Chemical Co. v. C.I.R., 391 N.E.2d 253 (Mass. 1979); Com. v. Embart Corp., 278 A.2d 916, 443 Pa. 397, appeal dismissed, certiorari denied 92 S.Ct. 451, 404 U.S. 981, 30 L.Ed. 2d 364 (Pa. 1971). Justice Kaplan's opinion for the Supreme Judicial Court of Massachusetts is an excellent exposition of the problem.

17. 601 P.2d 628 (Colo. 1979).

18. Id. at 632.

19. See, e.g., Montana Dept. of Revenue v. ASARCO, 567 P.2d 901 (Mont. 1977); ASARCO v. Idaho State Tax Comm., 592 P.2d 39 (Idaho 1979); Exxon Corp. v. South Carolina Tax Comm., 258 S.E.2d 93 (S.C. 1979); Wisconsin Dept. of Revenue v. Exxon Corp., 281 N.W.2d 94 (Wis. 1979).

20. See, Superior Oil Co. v. Franchise Tax Board, 386 P.2d 33 (Cal. 1963).

21. Probably the most often applied test is "whether the business done within the state is dependent upon or contributes to the operation of the business without the state." See, e.g., Coca Cola Company v. Dept. of Revenue, 533 P.2d 788 (Ore. 1975). Other tests include: (1) Whether there is unity of ownership, operation, and use. See, e.g., Chase Brass and Copper Co. v. Franchise Tax Board, 10 C.A.2d 496 (1st Dist. 1970); (2) Whether the business operations

are so interdependent that the net income of one corporation cannot reasonably be determined without reference to the operations conducted by the other commonly owned corporations. *Banker Nat'l Ins. Agency v. Montana Dept. of Revenue* 571 P.2d 1156 (Mont. 1977), *but see*, *Montana Dept. of Revenue v. ASARCO*, 567 P.2d 901 (Mont. 1977); (3) Operational interdependency. J. Hellerstein, "Recent Developments in State Tax Apportionment and the Circumscription of Unitary Business, 21 Nat'l Tax Jour. 487 (1968); and (4) the test contained in the MTC's regulations which will apply the doctrine where corporations are in the same type of business, are part of a vertical process, or in the case of a conglomerate where there is strong centralized management. See, Prentice Hall, *State and Local Taxes*, *supra* fn. 4.

22. According to Professor Pierce this ommission was intentional. Conversation with the author, May, 1980.

23. See, *e.g.*, *St. Johnsbury Trucking Co., Inc. v. State*, 385 A.2d 215 (N.H. 1978); *Ruby Construction Co., Inc. v. Departme of Revenue*, 578 S.W.2d 248 (Ky. App. 1978) and sources therein cited.

24. Prentice Hall, *State and Local Taxes*, *supra* fn. 14.

25. 395 N.E.2d 1167 (App. Div. Ill. 1979).

26. *Miles Laboratories Inc., v. Department of Revenue*, 274 Ore. 395, 400, 546 P.2d 1081, 1083 (1976).

27. *United States Tobacco Company v. Commonwealth*, 478 Pa. 125, 138-39, 386 A.2d 471, 478 *cert. denied*, 99 S.Ct. 217 (1978).

28. 441 U.S. 434 (1979).

29. 48 Law Week 4306 (1980).

30. 48 Law Week at 4307.

31. 48 Law Week at 4308.

Submission of

INTERNATIONAL BUSINESS MACHINES CORPORATION

International Business Machines Corporation (IBM) appreciates this opportunity to comment on S.1688, which we support. S.1688 addresses the practice of a few states which extend their tax jurisdiction by taxing the income of corporations operating solely outside the United States and having income derived from non-U.S. sources. These states extend that jurisdiction through an apportionment formula known either as "unitary" or "worldwide combined reporting."

IBM

IBM, which operates in over 120 countries around the world, derived approximately half its 1979 corporate revenue from sources outside the United States. Since IBM's products must accommodate national and special customer requirements without basic changes in design, the efficiencies of manufacturing these same products worldwide have been central in reducing computer costs to continually lower levels. Plants abroad are specialized by product to benefit from economies of scale. It is primarily because of our manufacturing presence in these countries that IBM has become an important supplier of information handling equipment and services abroad. Marketing and servicing in overseas environments are done by local sales and service personnel who are better attuned to local customs and requirements.

IBM's overseas operations have been of clear benefit to the U.S. domestic economy:

- In the 1975-79 period, IBM's balance of payments contribution to the U.S. was about $8.3 billion.

- In 1979, our provision for Federal income taxes on U.S. operations was about $1.2 billion. IBM's state income taxes in 1979 totaled $127 million.

The unitary system of income apportionment (unitary system) is thus of interest to IBM not only because it directly affects us in those U.S. states using it, but also because it affects economic relationships with those foreign countries where IBM operates, which are concerned about the effect on their corporations having U.S. subsidiaries located in unitary states.

UNITARY SYSTEM

The unitary system is unfair because it doubly taxes foreign income. It attributes to a state foreign income derived from manufacturing, marketing and service operations abroad, often in the absence of an explicit or implicit relationship between operations in the state and those overseas. This attribution results in state taxation of such foreign income in addition to the taxes already paid to the countries where those operations are conducted and where the income is earned. In 1979, IBM's effective tax rate on non-U.S. operations, before additional state taxes, was 47.7%, which is higher than the maximum U.S. statutory rate of 46%. Our rate on U.S. operations was 43.9%.

Within this context, IBM believes that the unitary system results in: (1) over-apportionment of income, for state tax purposes, by those states using it; (2) taxation by those states of income not taxed by the federal government and (3) potentially disruptive effects on international economic relationships between the United States and foreign countries which have corporations with subsidiaries in those states.

(1) Over-Apportionment of Income: Most states, in apportioning corporate income for tax purposes, use a three-factor formula based on payroll, sales and property value. The relative costs, among those three factors, do not widely vary domestically. The same apportionment ratio, applied internationally to a group of related corporations, as under the unitary system, can result in an overstatement of the amount of foreign source income, if any, attributable to the state. The same combination of principal factor ratios such as payroll, sales and property value can produce differing amounts of income in various counties. When combined with currency conversion and timing fluctuations, it becomes clear that applying a single ratio to income derived from many sources outside the U.S., as under the unitary system, is inaccurate and inequitable.

(2) Taxation of Income Not Taxed by the Federal Government: A fundamental tenet of international tax law and practice is that foreign source income is taxed by the home country when it is remitted. No country in the world, including the United States, taxes unrepatriated foreign source income. However, those states using the unitary system, because they apply their apportionment formula to related corporations abroad on a current basis, tax foreign source income when earned even if that income is never sent to the U.S. This state law not only exceeds the scope of federal law, which only taxes that income when it is remitted as a dividend, but also violates one of the most basic rules of taxation among countries.

(3) Potentially Disruptive Effects on International Trade: United States federal income tax regulations and those of our major trading partners determine the income of related enterprises in various countries on the basis of an "arm's length" pricing standard. That standard is, in addition, embodied in the model tax treaty of the Organization for Economic Cooperation and Development (OECD) and in the United Nations 1974 report on international corporations. For states to apply an inconsistent taxing method is potentially disruptive of trade and tax relationships with the major industrial countries.

Under the unitary system, records of related entities, in the United States and abroad, must be filed for state income tax purposes. The records of American-based corporations are generally kept in U.S. dollars, and they conform with U.S. accounting principles but are not usually in conformance with the varying state tax accounting rules. On the other hand, foreign-based international corporations with operations in unitary states are generally required to submit records to such states in U.S. dollars and in conformance with U.S. accounting principles even though it is highly unlikely that any foreign corporation would keep its non-U.S. records in such a manner. Thus, it must convert its worldwide records accordingly. Since the burden of this conversion process falls singularly on foreign-based corporations, it could be regarded by them as discriminatory.

Similarly, foreign governments do not tax American-based corporations at the national or local level on a unitary basis; therefore, they may believe taxation of their national corporations with operations in unitary states to be discriminatory and consider retaliatory action. State tax law should thus be brought into conformance with those tax principles of the federal government relating to foreign income in order to eliminate the disruptive nature of the unitary system on international trade."

COMPETITION

The foreign-owned companies with which IBM competes abroad enjoy tax treatment at least comparable to, and often more favorable than, the treatment the U.S. Government accords American companies. In addition, many of the foreign information handling companies which compete with IBM receive assistance from their governments in the form of direct subsidies, favored status for government procurement, research grants, and other direct and indirect forms of aid. The following chart indicates government research subsidies for the information-handling industry in major industrial countries:

Country	Amount	Period
France	$500 million	1980-85
Germany	540 million	1980-83
Italy	355 million	1979-81
Japan	116 million	1979-80
Sweden	111 million	1979-82
United Kingdom	540 million	1979-83

In France and the United Kingdom, the government also maintains equity participation in major national information handling companies. Japan has granted $1.7 billion in "soft loans" to its manufacturers in the 1973-1980 period.

IBM wants neither government assistance nor protection. We ask for nothing more than sensible tax and trade laws which recognize the need to maintain international competitiveness. While there may be debate as to whether tax legislation is the correct forum in which to promote such competitiveness, there can be no question that it is an inappropriate means to discourage it. The unitary system of state taxation penalizes those companies with international operations in many cases by doubly taxing the income derived thereof. Such double taxation runs counter to both an equitable tax policy and a meaningful trade policy.

S.1688

S.1688 would preclude application of the unitary system to non-U.S. corporations and thus remove an irritant between the United States and its major trading partners with subsidiaries in unitary states.

With regard to U.S.-based corporations, S.1688 has two advantages. First, states would be allowed to tax the foreign source income of corporations at the time the federal government taxed it, that is, when a dividend is paid to the U.S. shareholder. Second, an appropriate allocation formula would prevent states from taxing a greater portion of the dividend from a foreign subsidiary than the federal government effectively taxes. The combination of allowing states to tax foreign income only in the amount and at the time taxed by the federal government would resolve the conflicts between federal and state law which the unitary system creates.

In addition, the tax treatment of dividends from related foreign corporations proposed in S.1688 would, in general, be similar to the tax treatment accorded dividends from related domestic corporations.

IBM urges speedy enactment of S.1688 as a means of eliminating unfair state taxation of foreign source income of both U.S. and foreign-based companies.

STATEMENT OF DONALD G. SCHURMAN
VICE PRESIDENT AND TREASURER
ALCAN ALUMINUM CORPORATION, CLEVELAND, OHIO
TO THE FINANCE SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT
UNITED STATES SENATE
JUNE 24, 1980

I am Donald G. Schurman, Vice President and Treasurer of Alcan Aluminum Corporation, Cleveland, Ohio. On behalf of Alcan Aluminum Corporation, I heartily urge that the provisions of S. 1688, and especially Section 7518(a), be adopted. While we also support S. 983, my comments will be restricted to S. 1688.

Alcan Aluminum Corporation has annual sales of about $1.2 billion, assets in excess of $500 million, 21 fabricating plants, and more than 40 other operations including service centers and warehouses in the United States. In addition to filing a combined report in California, which is discussed more fully below, Alcan Aluminum Corporation files state tax returns based on income in 28 other states. Alcan Aluminum Corporation is a wholly-owned subsidiary of Aluminum Company of Canada, Limited, which in turn is owned by Alcan Aluminium Limited of Montreal, Canada, both Canadian companies. Alcan Aluminium Limited in turn has nearly 100 subsidiaries throughout the world.

INTRODUCTION TO SECTION 7518(a)

Although Alcan Aluminum Corporation supports S. 1688 because it resolves problems that multinational companies have had to struggle with for years, my focus today is upon Section 7518(a) of the Bill.

Section 7518(a) provides generally that no state or political subdivision may include in taxable income, the income of a foreign corporation which is a member of an affiliated group unless such income is subject to tax under Federal tax rules.

ILLUSTRATIONS OF COMBINED REPORTING

Perhaps it would be helpful to define what is meant by a combined report such as that used by California for related corporations held to be engaged in a so-called "unitary business" by reason of a unity of ownership, operation, and use.

A combined or consolidated report for state tax purposes is somewhat similar to the consolidated return that may be filed for Federal income tax purposes, but in contrast to the Federal consolidated return, a taxpayer can be required to file a state combined or consolidated return which includes the income and apportionment factors of a taxpayer's affiliates even though those affiliates do no business in the taxing state or the United States. An excellent illustration of California's combined reporting system is found in George Carlson's, "State Taxation of Corporate Income from Foreign Sources," published by the Department of the Treasury and contained in its Essays in International Taxation: 1976. Mr. Carlson's example is set forth below.

> "For example, suppose U.S. parent corporation A and wholly owned subsidiaries B and C form a unitary business and are engaged in the business of manufacturing and selling lathes. Corporation A manufactures lathes and does no business outside California. Corporation B sells lathes in California and other states, while Corporation C sells the lathes abroad and does no business in the United States. Since Corporations A, B, and C are a unitary group, a separate but combined return must be filed for Corporation A and Corporation B, each of which does business in California. Although Corporation C is not required to file a return in California, its income and apportionment factors are included in the combined return of the unitary group. The total income is apportioned to California by a 3-factor formula. Suppose that the payroll, property, sales, and taxable income for those corporations are as follows:

Corpor-ation	Payroll		Property		Sales		Taxable
	Total	Calif	Total	Calif	Total	Calif	Income
A	120	120	180	180	240	240	50
B	80	60	120	60	160	80	50
C	100	0	150	0	200	0	80
	300	180	450	240	600	320	180

Corporation A's taxable income in California under the unitary approach would be computed as:

$$\frac{120}{300} + \frac{180}{450} + \frac{240}{600} = 0.40 = \text{unitary apportionment factor}$$

$$0.40 \times 180 = 72 = \text{taxable income in California}$$

Corporation B's taxable income in California under the unitary approach would be computed as:

$$\frac{40}{300} + \frac{60}{450} + \frac{80}{600} = 0.133 = \text{unitary apportionment factor}$$

$$0.133 \times 180 = 24 = \text{taxable income in California"}$$

As the above example illustrates, combined reporting results in $96 of income being treated as taxable by California, an amount equal to all of Corporation A's taxable income (since it does business only in California) and almost all of Corporation B's taxable income - even though Corporation B's factors suggest that it does considerable business outside of California. Thus, it seems clear that a combined report effectively subjects to California tax the income of corporations such as B and C which derive only part, or none, of their income from business activity in California.

When applied to a corporation doing business in California with affiliates doing no business in the United States, the combined reporting requirement produces a manifestly unfair tax burden as illustrated by Alcan Aluminum Corporation's experience with California's combined reporting.

Alcan Aluminum Corporation has submitted California Franchise Tax returns for the years 1965 through 1978. The California Franchise Tax Board's policy of applying its unitary business concept which combines the incomes of a related group of corporations operating outside the United States will produce an additional tax on Alcan Aluminum Corporation for the years 1965 through 1978 of approximately $2 million. A refund proceeding has been commenced in California contesting the legality of such assessments.

In 1969, Alcan Aluminum Corporation incurred a loss in its United States operations that was sustained after an audit by the Internal Revenue Service. Nonetheless, by applying the combined three-factor formula against the worldwide income of Alcan's so-called "unitary group", the California Franchise Tax Board determined that Alcan Aluminum Corporation had income from California alone of $3.3 million and that a tax for such year of approximately $229,000 was due. The Board achieved this result by using combined reporting to determine the tax with reference to Alcan Aluminum Corporation's operations and the profitable operations of other corporations related to it through its Canadian parent that operate totally outside the United States, most having no operational connection with Alcan Aluminum Corporation whatsoever, much less with California. It seems clear that such a tax is levied on income earned not only outside California but outside the United States as well.

ANALYSIS OF SECTION 7518(a)

Section 7518(a) of the Bill presents a reasonable and workable solution to the problems faced by United States corporations with affiliates operating in foreign countries. It generally permits the filing of combined reports, but prohibits the inclusion in the report of the income of related foreign corporations unless such income is subject to tax under Federal tax rules.

We believe that Section 7518(a) is fair to taxpayers and the states and that it is consistent with general principles of international law and constitutional principles circumscribing the taxing power of the states as we understand them.

POSSIBLE VIEWS OF STATE TAX AUTHORITIES

Various state tax authorities have expressed the view that the combined reporting method for unitary businesses is simple, effective, and equitable; however, we do not believe that this is, in fact, the case. Combined reporting is said to be simple and effective because it is easier to audit a single company that computes its tax liability with reference to the combined income of a unitary group than to audit the separate returns of affiliates. Nevertheless, it would seem that the effort required for a thorough audit of a combined report should be as great as that required to audit the returns of the so-called "unitary" affiliates involved, because an audit of a taxpayer's combined report would seem to include an audit of the affiliates' figures, unless the affiliates' income and apportionment factors are accepted for state purposes without audit.

The combined reporting method is also said to be easier to administer since it prevents income shifting between separate corporations and does not require an analysis of arm's length transactions between affiliates similar to that of Section 482 of the Internal Revenue Code. We doubt, however, that combined reports are, in fact, generally easier to administer than returns filed under an arm's length standard because the factual investigation and legal analysis necessary in the first instance to establish the unitary group for a combined report is probably as difficult and time consuming as would be the administering of an arm's length approach.

We are also aware of the view that if combined reporting were limited, states using combined reporting under a unitary system would suffer a substantial decline in revenue. Whether or not such a limitation would actually result in a loss of revenue is of course difficult to predict, but it is interesting to note George Carlson's response to this concern in the Department of the Treasury's study, "State Taxation of Corporate Income from Foreign Sources," mentioned above. Mr. Carlson states at page 288:

> "Assuming that the unitary system is a device to measure California income, and not a device to tax foreign income, prohibition of the unitary system should involve little or no revenue change. However, California tax authorities have suggested that State tax revenues would decline by $125 million without the unitary system. The basis of this estimate is unknown."

While it is undoubtedly true that no resolution of this question can be achieved without controversy, we strongly believe that the reasons supporting Section 7518(a)'s limitation on combined reporting far outweigh any disadvantages that may be perceived to arise from such a limitation on combined reporting.

STRONG POLICY REASONS SUPPORT LIMITING COMBINED REPORTING

Section 7518(a) is a fair and reasonable compromise to an issue that has generated considerable controversy and litigation over the years.

If adopted, Section 7518(a) would halt the proliferation of combined reporting taxation in other states. Unless it is stopped, future investments in the United States will be adversely affected because of the fear that affiliates of multinational companies will incur substantial state taxes far in excess of the benefits of doing business in those states. We believe that adoption of Section 7518(a) will encourage foreign investment in United States industry and mean more jobs and income for workers.

By excluding certain companies from combined reporting, Section 7518(a) would provide long needed standards to help taxpayers comply with the combined reporting requirements of states such as California, since including foreign affiliates under the current methods presents substantial problems resulting from inadequate regulatory instructions as to how to prepare a combined report with respect to foreign affiliates subject to different tax and accounting rules. This difficulty in complying with the combined reporting requirement is often exacerbated by an inability to obtain the data necessary to ascertain (1) the affiliates that are to be part of the so-called unitary group and the affiliates that may be part of other separate unitary groups not generally recognized by the state tax authorities, and (2) the taxable income of foreign affiliates to be included in the combined report.

This latter problem is especially perplexing since, at least in California, the combined reporting instructions require taxpayers to begin with Federal taxable income in preparing a combined report, thus necessitating the conversion of income reported in foreign financial and tax statements into Federal taxable income concepts and figures which, when so converted, may well be foreign source income not taxable under Federal principles.

The state tax administrators seem to face the same problems. In our experience the California authorities have simply used the financial statement income of foreign affiliates in preparing their calculations of unitary income for the combined report, thus overlooking the important differences, recognized by the California rules, between Federal taxable income and income as reported in foreign financial statements. Our experience has also been that at the administrative level the California authorities have been unwilling to treat each year separately in determining which affiliates are indeed part of a unitary business subject to the combined reporting requirement, preferring instead just to assume that the unitary group does not change - thereby avoiding the massive factual investigation implicit in the unitary concept. We believe that Section 7518(a) affords an objective and uniform approach by which to determine whether a foreign affiliated corporation's income is includable in a combined report.

Section 7518(a) avoids the double taxation which can occur by reason of taxing a corporation doing business in California with reference to income generated and taxed in foreign countries, as demonstrated by the California position with respect to Alcan Aluminum Corporation's tax obligation to California for 1969 described above.

And, lastly and most importantly, we believe that Section 7518(a) represents a fair and reasonable attempt to permit combined reporting generally, while avoiding the serious questions under the Due Process, Equal Protection, Foreign Commerce, and Foreign Relations Clauses of the United States Constitution that are now in litigation which result from requiring foreign corporations not doing business in the United States to be included in a combined report.

CONGRESSIONAL ACTION IS APPROPRIATE AND NEEDED

We strongly support S. 1688 because it resolves in a reasonable fashion issues that are broader than the interests of any taxpayer or state and that significantly affect the economy and foreign relations of the United States. Congressional action is appropriate and necessary because of the long history of the inability of states and taxpayers to resolve these issues.

In conclusion, S. 1688 is a Federal solution to serious problems that is long overdue. It treats states and taxpayers fairly and is consistent with Federal and international standards of taxation. Accordingly, we strongly support the principles of S. 1688 and respectfully urge that it be adopted.

Thank you, Mr. Chairman.

Price
Waterhouse & Co.
CHARTERED ACCOUNTANTS

SUBMISSION TO FINANCE COMMITTEE

SENATE

CONGRESS OF THE UNITED STATES OF AMERICA

ON

BILLS S.983 AND S.1688

AND UNITARY TAX ISSUE

This submission is being made on behalf of a group of Canadian corporations having subsidiaries or operations in the United States, in order to express their concern to the Finance Committee of the United States Senate about the present practice of certain states in taxing income from sources outside of the United States under the so-called "unitary" concept of taxation. The Canadian corporations who have joined in making this submission are:

- ABITIBI-PRICE INC.
- ALCAN ALUMINUM LIMITED
- THE BANK OF NOVA SCOTIA
- THE CANADIAN IMPERIAL BANK OF COMMERCE
- HIRAM WALKER GOODERHAM & WORTS LIMITED
- INCO LIMITED
- MACMILLAN BLOEDEL LIMITED
- NORTHERN TELECOM LIMITED
- PANCANADIAN PETROLEUM LIMITED
- THE TORONTO-DOMINION BANK
- WOOD GUNDY LIMITED

Basic position

The Canadian corporations subscribing to this submission are strongly opposed to the international application of the unitary basis of taxation adopted by certain states in the United States. These corporations therefore affirm their support for the general objective of Bills S.983 and S.1688 which would preclude states, and their political subdivisions, from using the unitary method to tax the income of foreign corporations unless such income was subject to U.S. federal income tax.

The Canadian corporations participating in this submission all have substantial business interests and investments in the United States. Because of this, they are gravely concerned about the actions of certain states in the United States in seeking to tax an allocated share of the worldwide income of Canadian-based multinational corporations, and believe these actions could result in serious adverse consequences for the corporations' future investments and operations in the United States.

Unitary tax approach is arbitrary and unfair

Under the unitary approach to income taxation, the amount of income arbitrarily allocated to a state and hence subject to its income tax is determined by applying various factors to the worldwide profits of the corporate group, without regard to where these profits are in fact earned. It is obvious that the actual profitability of different segments and divisions and subsidiaries of a multinational group will vary substantially, because of differences in the businesses being carried on, the selling prices and costs incurred in different locations, local economic conditions and trends, and many other factors. For example, because California tends to be a relatively high cost jurisdiction in world terms, the use of a three-factor apportionment formula based on salaries, property and sales tend to have the result, in many cases, of allocating more income to California than is in fact earned in California. The fact that particular operations in California tend to have higher capital costs and higher payrolls because of local cost and wage levels is not necessarily an indication that operations in California are correspondingly more profitable than operations elsewhere, and indeed the converse may be the case. The use of an arbitrary formula based on worldwide profits ignores all of these real differences in local profitabilities and ignores the efforts of the business to allocate income reasonably amongst its various units through establishing arm's length prices for the transfer of goods and services.

The employment of an arbitrary formula to allocate the income earned by a company in a particular country amongst that country's political subdivisions for local tax purposes may be acceptable on the grounds of expediency, since it avoids difficult problems of allocating income on a factual basis amongst a large number of subdivisions in those circumstances where the enterprise does not maintain accounting records to provide this information. However, the use of such formulas to allocate income on an international basis is objectionable, since it disregards the separate determination of national incomes already established for corporate accounting and national tax purposes, and could subject foreign income of a multinational group to state taxation even though U.S. federal tax laws would not tax such income because it had been earned outside of the United States.

It is recognized that the determination of income allocable to California or other states or jurisdictions under a formula based on total worldwide income can result in a tax liability which can either be greater or less than the tax calculated on the "actual earnings" in that state (or an allocated share of only the national income of the company concerned). However, it is the experience of the companies joined in this submission that the unitary appoach has frequently resulted in such corporations being subjected to substantial additional taxation, over and beyond that which would be imposed on income actually earned in these states. For example, Canadian companies which export Canadian-produced goods to their affiliates for sale in the

United States may find that the application of the unitary formula can lead to a portion of the group's manufacturing or mining profits clearly earned in Canada being subject to tax in a U.S. state; and may find that the unitary tax approach can in extreme cases lead to virtually confiscatory taxation of the actual profits earned in a state. Indeed, the efforts of a number of state tax administrations to support and retain the unitary tax approach is some indication in itself that this approach may well extract additional revenues over those that could be collected if the tax base was confined to income actually earned in the state.

Unitary tax a destabilising factor in international commerce

The actions taken by certain states in adopting and following the unitary approach are particularly disturbing because they may in time lead other states in the United States, and other countries and their political subdivisions, to adopt a similar basis of taxation with potentially disastrous effects on the international flow of trade and capital. The use of such formulae to allocate income on an international basis would lead to substantial new elements of international double taxation, particularly because of inevitable differences in income allocation methods amongst the jurisdictions. Furthermore, the present actions of such states may conceivably induce other taxing jurisdictions outside of the United States to retaliatory action against these arbitrary measures. The continuance of the unitary tax approach by state governments in the United States is therefore a disharmonizing factor in international fiscal relations, and could encourage other developments which would have an adverse impact on international trade and investment.

It is also submitted that the action of certain states in applying the unitary concept to worldwide operations imposes an unreasonable burden on foreign corporations doing business in the United States, and is contrary to the longstanding fiscal policy of the United States government to treat international commerce uniformly and to improve the country's balance of payments through encouraging additional investment and employment in the United States.

Practical difficulties of compliance

Canadian-based corporations with operations in the United States are also concerned that the assessment of tax on a unitary basis by California and other state governments requires disclosure to these governments of detailed information on operations, assets, sales, and expenses relating to activities carried on outside of California and indeed outside the United States. Such information can be extraordinarily costly and sometimes virtually impossible to obtain, as it must be stated in U.S. dollars and be in accordance with U.S. tax and accounting principles.

In some cases, the only possible result is that the Canadian corporation has to accept an arbitrary assessment of its state tax liabilities, simply because it would be impossible or unduly burdensome, particularly years later, to prepare the voluminous material needed to determine the "correct" state tax due under the unitary approach.

Unitary tax offends international tax principles

The unitary tax concept is contrary to accepted international standards of income allocation and determination, as expressed in Articles 7 and 9 of the OECD Model Convention for the avoidance of double taxation with respect to taxes on income and capital, (which provisions are intended to apply to political subdivisions also).

Further, the actions of these states are inconsistent with the principles used to determine the income earned in each jurisdiction under the present tax treaty between Canada and the United States (under Articles I, III, and IV of the Canada-United States Tax Convention).

Price Waterhouse & Co.
CHARTERED ACCOUNTANTS

Summary

The action of California and certain other states in the United States in imposing tax on foreign multinational corporate groups under the unitary concept have subjected some Canadian companies and their affiliates to substantial additional taxation, as well as increased compliance costs. This additional taxation is being imposed on a basis which is contrary to accepted principles of international tax relations between friendly nations, and is in opposition to such principles as expressed in the Canada-U.S. Tax Convention.

These additional taxes and costs are hampering the ability of Canadian corporations to expand their operations, investment and employment in the United States, and may even be so severe as to require a reassessment of present operations in certain states.

The Canadian corporations participating in this submissions respectfully asks the Committee, and The Congress of the United States of America, to give favourable consideration to the general principles embodied in Bills S.983 and S.1688, in order that the international flow of trade and capital between the United States, Canada and other countries not be impeded.

*** *** ***

This submission has been prepared on behalf of the corporations enumerated above by Price Waterhouse & Co., Canada.

TORONTO, CANADA
June 18, 1980

STATEMENT OF JAMES R. ZAGEL, DIRECTOR OF REVENUE, STATE OF ILLINOIS, ON S.1688 TO UNITED STATES SENATE COMMITTEE ON FINANCE, SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

Illinois is opposed to any attempt to restrict its right to tax "business income" on a combined corporate basis. It is also opposed to any attempt to exclude from its tax base the dividends paid by foreign corporations.

Our opposition is based upon several reasons:

1) Illinois provides many benefits and services to corporations for which it can fairly ask for something in return;

2) The present system of formulary apportionment is a workable, practical and fair method of measuring the amount of income which is earned from related domestic and foreign operations;

3) This legislation would cause a substantial loss of revenue and an unjustifiable change in the tax burden imposed on individuals and corporations;

4) The United States Supreme Court and the State Supreme Courts have consistently affirmed the right of each state to tax its proportionate share of all of the income earned by a business which operates within that state and throughout the world; and

5) This legislation creates a tax preference for multinational corporations at the expense of the states.

The states provide many services to corporations and their employees. If a corporation does business in Illinois, it can rely upon Illinois to maintain good highways as well as mass transportation systems. It can rely upon Illinois to provide sound educational programs so that businesses will have a talented work force and so the children of their employees can receive a good education. The state provides police protection for individuals and property. It sponsors programs which promote public health, public safety and employment opportunities. Moreover, Illinois sponsors specific programs to promote economic and community development.

All of this takes revenue. The tax burden is shared by individuals and corporations. If a corporation conducts business within and outside our state, Illinois has adopted a method of taxing income which is used by practically all other states. Forty-five states impose an income tax on corporations. Forty-four states use a three-factor apportionment formula. (Prentice Hall, All States Tax Reporter, para 223.) This method, known as formulary apportionment, compares the property, payroll and sales of a business within the state to the property, payroll and sales of the entire business. The average of these three-factors is multiplied by taxable income. Leaving aside the question of how Illinois determines what is business income as opposed to nonbusiness income and the question of whether corporations should be taxed on an individual or a combined basis, several observations about the apportionment formula are important.

1) Property, payroll and sales give a fair representation of the scope of business activity conducted within a state.

2) If all of the states use a three-factor apportionment factor, all of a corporation's income will be taxed, no more and no less.

3) Not only is the apportionment formula a relatively easy way of determining the extent of business activity conducted in one state, it is the only practical way. Any alternative would pose an administrative nightmare in terms of time and money spent on auditing. It is virtually impossible for any state to examine each corporate purchase and sale transaction and then calculate exactly how much profit was earned in each state. Corporate taxpayers would be invited to devise methods of accounting which, though based upon generally accepted accounting principles, do not accurately measure income for state tax purposes.

Multistate and multinational corporations enjoy several advantages over smaller, single-State firms. One of their advantages is that "Financial power inherent in the possession of assets may be applied, with flexibility, at whatsoever point within or without the state the managers of the business may determine." Ford Motor Co. v. Beauchamp, 308 U.S. 331 (1939). This multistate and multinational power to employ assets and earn profits at advantageous locations vitally affects State taxation. A corporate home office in Illinois may conduct expensive research and devote months of executive effort on a critical business decision involving sales by an out-of-state subsidiary. The actual sales will occur in another State or another country but rarely will the profits (or losses) be reflected on the Illinois parent corporation's books and records.

The State Supreme Courts have consistently decided in favor of the states' determination of what is and what is not "business income." The courts have found the income to be taxable in each of the following cases:

Qualls v. Montgomery Ward & Co., 585 S.W.2d 18 (Ark., 1979) (interest on loans to subsidiary, affiliate, parent and related corporations); W.R. Grace & Co. v. Comm. of Rev., 393 N.E.2d 330 (Mass., 1979) (gain on sale of Miller Brewing Co.); Albany International Corp. v. Halperin, 388 A.2d 902 (Me. 1978) (capital gains, royalties and interest); Montana Dept. of Rev. v. American Smelting and Refining Co., 567 P.2d 901 (Mont., 1977), appeal dismissed, 434 U.S. 1042 (1978) (dividends, interest and capital gains); ASARCO, Inc. (formerly The American Smelting and Refining Co.) v. Idaho State Tax Comm., 592 P.2d 39 (1979), remanded for reconsideration [illegible] U.S. [illegible] (March 24, 1980) (interest, rents, royalties, capital gains and some dividends were "business income," some [illegible] dividends were "nonbusiness income.") Atlantic Richfield v.Colorado 601 P.2d 628, (1979) (interest paid by and capital gains on sale of business-related corporation.)

These state court opinions with Moorman Manufacturing v. Bair, 437 U.S. 267, 98 S.Ct. 2340 (1978) Mobil Oil Corp. v. Vermont, _______ U.S. _____ (March 19, 1980, Docket No. 78-1201), and Exxon Corp. v. Department of Revenue of Wisconsin, _______ U.S. _______ (June 10, 1980, Docket No. 79-509), have held that the geographical source and the functional source of income are irrelevant to state income taxation. States may apportion income if it is business income or income from a "unitary business."

It is clear from the court decisions, particularly, the recent decision in Mobil Oil, that dividends paid by foreign corporations may be taxed by the states without violating the Due Process Clause, the Interstate Commerce Clause or the Foreign Commerce Clause of the United States Constitution. The Supreme Court has observed, in Moorman and Mobil Oil, that Congress may pass legislation with regard to state income taxation in general or with regard to foreign dividends in particular. However, these comments applied to legislation which would promote uniformity among the states. By uniformity, we mean the avoidance of the potential problem which arises when one state apportions part of the dividends and another state allocates all of the dividends.

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The Supreme Court did not suggest that certain types of income may not be taxed by any state because its "geographical source" "corporate source" or "functional source" is outside of the taxing state.

S.1688 would exclude from state taxation dividends paid by foreign corporations. This is not regulation of foreign commerce. This is the creation of a tax preference for multinational corporation at the expense of the states. The proposed law is not one which requires foreign commerce to be treated in a manner similar to interestate commerce. Nor is it a law which permits all states to apportion dividends and forbids any state to allocate dividends, thereby achieving uniformity among the states. The law simply creates a tax preference for income received in the form of foreign dividends. It is one thing if Congress creates this preference for federal tax purposes. It is entirely different to make the states pay for the benefits which will be bestowed upon the multinationals. This is a violation of the proper rights of the states.

Corporate taxpayers and accountants can and will point to many differences among the income tax laws of the states. However, differences among the states, by themselves, are not a basis for enacting federal legislation. Only if taxpayers can show multiple taxation in fact of foreign dividends and that there is no effective judicial remedy should a law be considered and then such a statute should only address the question of apportionment among states and should not entirely exclude foreign dividend business income from state taxation.

With regard to combined reporting, it is important to realize that it is the alternative to taxing foreign dividends received by a corporation. If Illinois taxes the combined income of affiliated corporations, it will not also tax the dividends each corporation pays to others.

Combined reporting is a necessary extension of the concept of apportionment of the income of a "unitary business." The apportionment of unitary business income for state tax purposes has been sanctioned by the courts for decades. [*Adams Express Co. v. Ohio*, 165 U.S. 194 (1896), rehearing 166 U.S. 185 (1897) (an ad valorem property tax); *Underwood Typewriter Co. v. Chamberlain*, 245 U.S. 111 (1920); *Bass, Ratcliff & Gretton v. State Tax Commission*, 266 U.S. 172 (1924); and *Moorman Manufacturing Co. v. Bair*, *supra*. (net income tax cases); and *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911); *Ford Motor Co. v. Beauchamp*, 308 U.S. 313 (1939) (net worth or franchise tax cases).] In *Mobil*, the Supreme Court held that its famous *Bass Ale*, *supra*, decision "...is the leading example." This 1924 case arose between the State of New York and the British manufacturer of Bass Ale. This brewer objected vehemently to paying any New York tax at all since it was not even subject to federal tax. Conversely, New York had a tax which compared Bass Ale's business activities in New York with its business activities throughout the world. Through this apportionment method, New York determined what portion of Bass Ale's world-wide profits were actually earned in New York. Bass Ale took the case to the United

States Supreme Court on the premise that New York was unconstitutionally seeking to tax profits that were *actually earned abroad*, not in New York. The *Mobil* Court observed that in these circumstances, it had ruled fifty-six years ago:

> ...the brewer carried on a unitary business, involving 'a series of transactions beginning with the manufacture in England and *ending in sales* in New York and other places,' and that 'the State was *justified* in attributing to New York *a just proportion* of the profits earned by this Company from such unitary business.' (emphasis added)

That identical principle is challenged by the proposed legislation. Illinois and every other State has the right to tax a fair proportion of the income earned by a multinational business which operates within the taxing state and throughout the world.

Combined reporting is a recognition that a "unitary business" may consist of more than one corporate entity. Increasingly today, a "unitary business" is conducted by more than one corporation. To limit the states to taxing corporations which have a physical presence in their state would not only create tax preference for foreign source income and would interfere with the rights of states to tax income which is earned, in part, in their respective states, but also undoubtedly lead to a restructuring of business activity in order to avoid state taxes. For instance, if a business conducts only marketing operations in a given state, it could form a corporation to operate those limited activities. The profitability of that corporation would depend on its cost of good sold. Thus, profit could easily be attributed to either the purchasing or the selling corporation. Any vertically integrated business could benefit unfairly from this type of tax planning.

The decision of the United States Supreme Court in Exxon Corp., supra, on June 10, 1980 presents a further illustration of this point. Despite Wisconsin sales in excess of 60 million dollars, Exxon claimed that it did not owe any tax to Wisconsin for years 1965-68 because, according to its accounting, its sale of gasoline within Wisconsin resulted in a loss. Its exploring, production and refining operations, all of which occurred outside of Wisconsin, operated at a profit. The Wisconsin Department of Revenue argued, and the Supreme Court agreed, that the marketing as well as the exploring, production and refining operations were all part of a "unitary business" and should be taxed as such. The method of apportionment adopted by Wisconsin was fair. Exxon's method of "functional accounting", or accounting fpr each phase of its integrated business, was unacceptable for state tax purposes.

Exxon operated the different phases of its business as separate divisions rather than separate corporations. Under this legislation, Exxon could avoid the result of its legal battle by incorporating each of its divisions as a separate corporation. Similarly, any integrated business could reduce or avoid its state tax liability simply by changing its corporate structure.

The effect of S.1688 is profound. It artifically discriminates in favor of multinational corporations. It discriminates against domestic corporations of every variety, from the small, family-owned corporation to the huge multistate (domestic) chainstores. It represents a substantial, unjustifiable redistribution of State income taxes. It encourages multinational corporations to do what multistate corporations often did before the Uniform Act: viz ... flexibly apply their assets and earn their profits in locations which allow it to avoid or minimize State taxation. In these times of acute financial stress, S.1688 encourages creation of more multinational operations in the cause of maximum corporate profitability. It creates an unconscionable distortion of Multinational corporate income. It would deny, for example, in the case of Mobil Oil, that all of the billions of dollars spent for international exploration and refining would be meaningless but for its United States sales outlets. It is Mobil Oil's gas stations in each of our 50 States where Mobil recaptures its cost and earns its profits. To exclude consideration of Mobil Oil's foreign source income in Illinois tax base and fair apportionment would be nothing less than an unjustified loophole for multinational corporations and a burden on domestic corporations.

Finally, one obvious reason for the state's objection to S.1688 is the loss of revenue. The effect on state revenues is difficult to estimate because the amount of foreign dividends is not shown as a separate item on the state tax return. It is a separate item on the federal returns - in 1974 dividends received from foreign corporations totaled $7,443,000,000. ["Statistics of Income - 1974, Corporation Income Tax Returns, p. 20 published by the Department of the Treasury, Internal Revenue Service.] It can be reasonably estimated that five to ten percent of the foreign dividends would be apportioned to Illinois. Given an Illinois corporate income tax rate of 6.5% the revenue loss would be between $24 million and $48 million annually. It is impossible at this time to give a meaningful estimate on the revenue affected by combined reporting, although, because combined reporting is an alternative to taxing foreign dividends, probably the same revenue is involved regardless of the method.

As you know, Illinois is the largest exporting state in America and the home base for some multinational corporations. Just as in any other state, Illinois is seeking to attract more industrial investment, not lose it. S.1688 would decrease Illinois taxes on these multinational giants, but only temporarily. Astute Illinois businessmen, who examine the big picture and not just shortterm results, should not support this bill. Rather, they know, that in these times, Illinois cannot afford the cut in revenues which would necessarily follow.* Some other tax would have to be enacted to make up for these lost revenues, and such a result might well be worse than the taxes they now pay.

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*In fiscal year 1978 (most recent year available for all states). Illinois ranked 43rd in State tax burden. Computed from State Government Finances: 1978, Department of Commerce unpublished as of December, 1979.

The recent decision by the United States Supreme Court in Mobil Oil v. Vermont acknowledged the right of the states to tax foreign dividends when they are found to be part of a unitary business. The Court in Exxon v. Wisconsin affirmed the right of the states to tax their proportionate share of all of the income of a unitary business, regardless of the purported profitability of each phase of the business. Congress should not put beyond the reach of the states income which is related to business activities conducted within the states, especially when the states are called upon to provide benefits and services to the businesses and their employees.

Pfizer

PFIZER INC., 235 EAST 42nd STREET, NEW YORK, N.Y. 10017

P. H. FRIEDMAN
VICE PRESIDENT, TAXES

June 23, 1980

The Honorable Harry F. Byrd, Jr.
Chairman, Senate Finance Subcommittee on
Taxation and Debt Management Generally
U. S. Senate
Washington, D. C. 20515

Re: S. 1688

Dear Mr. Chairman:

This statement is submitted in support of S. 1688 by Mr. P.H. Friedman, Vice President of Taxes for Pfizer Inc., 235 East 42nd Street, New York, New York, (212) 573-3213.

S. 1688 should be adopted because:

It would bring all the States into conformity with Federal tax policy.

It would simplify tax administration.

It would remove a serious obstacle to successful completion of mutually beneficial tax treaties by permitting the Federal Government to speak with one voice in its dealings with foreign governments concerning taxation of foreign source income.

It would remove any hint of Federal sanction of a tax practice that, if adopted by other countries, would be harmful to the U. S. economy.

It would remove the impediment to new investments in those states which now employ the world-wide combination method.

It would place subsidiaries of U. S.-based corporations on a more equal footing with their foreign competitors.

S. 1688 would accomplish these goals by requiring that:

1. a state may not subject to tax the income of any foreign corporation prior to the year in which such income is taxed under the Internal Revenue Code, and

2. in the case of dividends received by a U.S. parent corporation from a foreign subsidiary, S. 1688 would permit a state to tax no greater portion of that dividend than the Federal government effectively taxes.

The primary object of this bill is to promote uniformity between federal and state formulae which tax foreign source income. The present divergence of philosophical and jurisdictional approaches to the taxation of such income has been the subject of much litigation in recent years. Critical decisions of late by the U.S. Supreme Court, including Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978); Japan Line Ltd. v. County of Los Angeles, 441 U.S. 434 (1979); Mobil Oil Corp. v. Vermont, 48 U.S.L.W. 4306 (3/18/80); and Exxon Corp. v. Wisconsin Dept. of Revenue, ______ U.S. ______ (1980), have further confused and complicated the status of multistate and multinational taxation in each of the state taxing jurisdictions in the country. The confusion resulting from these Supreme Court decisions is but the tip of the iceberg. Hundreds of tax cases are docketed in the state courts involving interstate and foreign commerce issues. Hundreds more are bogged down at various levels of appeal in the state administrative review process.

The frustration experienced by the lack of a clear and uniform tax policy in interstate and foreign commerce is not limited merely to interstate squabbles. Our foreign trading partners are seriously disturbed by the attempts by some states to tax income generated by companies licensed and operating exclusively in their jurisdiction. The international complaints are numerous and a few will be outlined here to make the point.

The dispute of most note has centered around Article 9(4) of the recently approved U.S.-U.K. Tax Treaty. The British Government sought this clause to prevent the state from taxing United States subsidiaries of U.K. countries on the earnings of the U.K. parent. Consistent with generally accepted international tax accounting, the U.K. Government saw no basis for such extraterritorial jurisdiction. The annexation of taxing jurisdiction by the states was not their only concern. The threat of the states' subpoena power to demand the books and records of the U.K. companies also raised serious international issues which are not in the interest of a free international commerce. These are not hypothetical problems. One need only look at the litigation presently in the Federal District Court in California involving EMI, a U.K. company, Capitol Records, a U.S. subsidiary, and the California

Franchise Tax Board. EMI and Capitol Records are challenging the right of California to tax Capitol on the income of EMI and to examine the books and records of EMI. EMI does not conduct any business in California.

Article 9(4) was not approved by U.S. Senate, with many Senators relying on federal legislation, such as S. 1688, to resolve the problem. The treaty, with the reservation of Article 9(4) was reluctantly approved by the Parliament only after Rep. Al Ullman, Chairman of the House Committee on Ways & Means, represented to several visiting Members of Parliament that he would hold hearings in this matter.

The position of our British allies was rather well stated in the Parliamentary Debate on the treaty held in the House of Commons on February 19, 1980 by Mr. Michael Grylls, to wit:

> "Mr. Michael Grylls (Surrey, North-West): Like my hon. Friend the Member for Crosby (Sir G. Page), I was asked to help in this matter by a number of leading British companies. I have been with him to the United States on a number of occasions during the past nine months to try to assess the possibility of legislation. I also have an interest to declare.
>
> In 1978 the Senate considered the convention and the so-called Church reservation was put in. That was a setback for the British Government. A major part of that convention had been shot out. The Government found themselves obliged to accept the convention, with a major part that was of great importance to British companies removed. Perhaps we can learn a lesson from that. ****
>
> Many of our most important companies operating in the United States were at great risk as a result of article 9(4) being removed from the convention. They are subjected to the vagaries of that extraordinary and unfair taxation system throughout the United States.
>
> At present EMI is involved in a court case in California. It was asked to produce figures for its business in England. Part of that business concerns defense and is covered by the Official Secrets Act. EMI wrote to California saying that it could not disclose that information on penalty of imprisonment, because of the Official Secrets Act. California nevertheless imposed a 25 per cent tax penalty for non-disclosure. That is an illustration of what British companies are subjected to.
>
> The world-wide reporting basis is not only unfair, as my right hon. Friend described, it has been perceived by the Californians to be counter-productive. British and other companies that are subjected to the tax will, at the end of the day, withdraw. ****

> One cheerful factor is the comment of the United States Supreme Court that counters the argument of those who stress the delicacy of matters related to state rights. The Supreme Court said:
>
> > "The United States must speak with one voice when regulating Commerce with foreign Nations".
>
> It is not right for individual states to speak with different voices on matters of international business. We are relying on them. Britain has the biggest investment of any foreign country in the United States. We are the closest of friends. I am sure that we want to go on investing and expanding business there. I am sure that this also benefits the United States.
>
> It will be a tragedy if the matter is not put right in California, Oregon and the other states and dealt with in a proper federal way, so that we can go on investing there. Their system of taxation is dangerous and short-sighted. Indeed, it is increasingly being seen by the states as a short-sighted policy and a mistake. Many countries have made mistakes in taxation and they are wise if they change."

Criticism abroad of the worldwide unitary approach utilized by several states is not limited to the U.K. At its Paris meeting in July, 1979, the Council of the OECD denounced the "global" method of taxation utilized by these states and endorsed the "arm's length price" as the guiding principle in determining taxable profits in each country where the complex nature of a business crosses fiscal frontiers. Transfer Pricing and Multinational Enterprises, (OECD, Paris, July 1979, at pp. 14-15.)

The criticism has been just as furious at home. Senator Howard Baker, in the U.S. Senate Foreign Relations Committee Report on the Third Protocol to the U.K. Tax Treaty, was unequivocable in his assessment that worldwide combination "almost be definition, ... prevents the Federal Government from 'speaking with one voice' in commercial relations with foreign governments." Senator Baker's comments, in applicable part were as follows:

> "Under the unitary method of taxation on a worldwide combined reporting basis, any one of the States of this Union has the opportunity unilaterally to establish tax liability for local subsidiaries of foreign multinational corporations. Although Congress alone has the power, under the Constitution, to "regulate Commerce with Foreign Nations," the States may incorrectly interpret the Senate's reservation to Article 9(4), and the Third Protocol to this Convention, as an invitation to establish tax policies applicable to foreign source income which are inconsistent or incompatible with broad National tax policies.

> In the landmark case of Japan Line, Ltd. v. County of Los Angeles, No. 77-1378, decided April 30, 1979, the U.S. Supreme Court held that a State of this Union may not tax the instrumentalities of foreign commerce if the tax "...creates a substantial risk of international multiple taxation, and...prevents the Federal government from 'speaking with one voice when regulating commercial relations with foreign Governments.'" (Slip Opinion 16). There is no doubt that the unitary method of taxation on a worldwide combined reporting basis creates a substantial risk of multiple taxation of international operations. Almost by definition, that method prevents the Federal Government from "speaking with one voice" in commercial relations with foreign governments.
>
> X X X
>
> The precedent of unitary taxation on a worldwide combined reporting basis cannot be established by this country without probable retaliation by scores of countries around the world whose ambition may extend to those profits of U.S. multinational corporations generated beyond their jurisdictional limits. (emphasis added)

The potential for retalitatory measures by our foreign trading partners is hardly in the best interests of the United States or of U.S. industry with operations abroad. Should other countries, or subdivisions thereof, also adopt extraterritorial taxing policies which would tax subsidiaries licensed or operating within their jurisdiction on the income of related companies licensed and operating in the U.S., then U.S. based multinational companies would be subject to irrational double taxation of its income. The natural consequence of this squeeze is reduced profits for U.S. based companies compared with foreign competitors. Ultimately, U.S. exports, jobs, capital formation, and international trade payments must suffer.

The U.S. Treasury Department has been seriously concerned with the adverse reactions of foreign governments to the unitary formula. This concern was most recent expressed by Mr. Donald Lubick at the May 1980 Hearings conducted by the House Ways and Means Committee. From a federal viewpoint, they have always recognized that the country in which the income is earned has the primary jurisdiction to tax such income. The Internal Revenue Code does not permit taxation of such income until it is repatriated. Furthermore, in order to prevent double taxation of such income, a credit for foreign income taxes is provided. Absent such a credit mechanism, there would be insufficient profits remaining after a two tier tax to encourage or permit U.S. businesses to expand abroad.

It is most important to point out that, in S. 1688, Congress would impose no more restrictions upon the state taxing powers that it has placed upon the U.S. Treasury in taxing foreign source income. The bill merely would defer taxation by the states of foreign source income of foreign affiliates until it is taxed under the Internal Revenue Code and would restrict duplicative taxation by permitting the states to tax only that portion of dividends effectively taxed by the U.S. after recognition of the foreign tax credit.

Under the present federal tax system, dividends received from a domestic company are excluded from federal income tax under Sec. 243 of the Internal Revenue Code. Although this section does not exclude dividends received from a foreign subsidiary, the foreign taxes paid by the subsidiary with respect to those dividends are allowed as a credit under Sec. 901 et seq. Thus, the federal system guarantees that the subsidiary's income is effectively taxed only once. If the dividend is distributed by a domestic corporation, the income is taxed at the subsidiary level and protected from a second tax at the parent level by Sec. 243. If the dividend is from a foreign subsidiary, any U.S. tax thereon is reduced by the foreign taxes paid by or withheld from the subsidiary.

However, the State system of taxation is different. Most states begin their calculation of corporate income tax with federal taxable income, which includes the deduction for domestic dividends only. However, the states do not provide relief from the two tiers of taxation of a dividend received from a foreign subsidiary, since there is no state provision comparable to the federal foreign tax credit. Thus, under present law, the asymmetry is two-fold: 1) foreign dividends are taxed by the states while domestic dividends are not, 2) state tax policy is at odds with federal tax policy.

The underlying philosophy for the federal treatment of such income is sound and long-standing. For the many reasons discussed herein, state tax law as it pertains to such income should be in conformity with this federal policy. Only then will the conflicting state laws be made uniform; only then will the criticisms of our foreign trading partners be silenced; only then will American business have some assurances that their profits will not be taxed to a greater extent than its foreign competitors; and only then will federal uniformity be paramount so that the federal government may speak with one voice when regulating commercial relations with foreign governments.

Respectfully submitted,

P. H. Friedman

P. H. Friedman
Vice President - Taxes

/ln

Statement Submitted by
Mr. Douglas D. Bell, Executive Secretary,
California State Board of Equalization,
for Inclusion in the Printed Record of the
Senate Finance Subcommittee on Taxation
and Debt Management Hearing
on June 24, 1980 on S. 983,
the "Interstate Taxation Act of 1979."

The California State Board of Equalization (Board) appreciates this opportunity to submit its opinion to the Subcommittee regarding S. 983, an act concerning state taxation of interstate commerce.

The Board administers the California sales and use tax and wishes to direct its comments to the provisions of S. 983 which affect such tax. The Board annually collects over seven billion dollars in state and local sales and use taxes. Over 599,000 businesses are registered with the Board; over 15,000 accounts are registered with the Board's Out-of-State District Office, of which over 5,000 accounts are registered solely for use tax collection purposes. The Board maintains offices in New York City, Chicago, and Houston. For the fiscal year ending June 30, 1979, the Board's out-of-state audit program developed tax underpayments in excess of

$27,000,000 and tax overpayments, which resulted in refunds, in excess of $1,890,000.

The State of California imposes a sales tax upon the sale of tangible personal property in California. The various cities and counties in California have been authorized by the Legislature to impose by ordinance local sales taxes. Local governments imposing sales taxes are required by law to contract with the Board for the Board to administer the locally imposed sales taxes. The result is a combined state, county, and city tax imposed throughout the state at a uniform rate of six percent. The combined tax is administered by the Board. Taxpayers are required to file a single return with a single agency. In addition to the taxes referred to, there are certain transit district taxes imposed in five counties in this state at a rate of 1/2 percent. These taxes are also administered by the Board and are integrated into the general return and collection system operated by the Board.

In addition to the sales tax, the State of California and the various counties, cities, and transit districts impose a use tax on the use within the taxing jurisdiction of tangible personal property purchased for use within the jurisdiction. The use tax is imposed at the same combined rate as the sales tax and upon the same tax base. The California state sales tax was enacted in 1933, and the use tax followed closely in 1935, to protect the integrity of the sales tax system--in essence to close a loophole. The use tax works to protect local merchants, who must pay sales tax with respect to their sales of tangible personal property, from the unfair competitive advantage which would otherwise be available to out-of-state merchants who would be able to sell property to California residents for use in California without tax cost.

The California use tax is imposed upon the purchaser who acquires property for use in this state, but the tax must be collected by retailers who are engaged in business in this state and must be remitted by the retailer to the state. It is this collection feature which makes the use tax system workable.

Our Sales and Use Tax Law provides, in Revenue and Taxation Code Section 6203, that out-of-state retailers are engaged in business in this state for purposes of imposition of the use tax collection responsibility if they maintain a place of business in this state or if they solicit orders in this state, through employees or independent contractors. Since 1954 and 1960, we have found guidance as to the jurisdictional limits of the collection imposition feature of our law in the decisions of the United States Supreme

Court in Miller Bros. v. Maryland, 347 U.S. 340, the delivery case, in Scripto v. Carson (3/60), 362 U.S. 207, the solicitation case, and, since 1967, in National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753, the mail order case.

It is the Board's opinion that experience has borne out its long standing belief that the need for federal intervention into the sales and use tax system has always been overstated and that no such federal legislation should be enacted. California has had a continuing interest in this issue since the original Willis bill, H.R. 11798, was introduced in the House of Representatives on October 22, 1965. Since that time many of the acknowledgad problems have been resolved--particularly the problem of double taxation which has disappeared with the various states having incorporated credit provisions into their individual laws.

The Board is not saying that out-of-state etailers face no problems in complying with the California ales and Use Tax Law. The Board is saying that in its pinion those compliance problems are generally no greater han the compliance problems faced by local merchants. ndeed, it was the finding of the Special Subcommittee n State Taxation of Interstate Commerce, in its eport to the House of June 30, 1965, following the Willis earings, that "Interstate companies collecting tax on nearly all of their sales reported costs lower than those of most types of local retailers." The report characterized compliance costs of interstate sellers as "generally insignificant." The validity of this finding is supported by the fact that there are a number of out-of-state businesses which, under current jurisdictional standards, are not legally required to collect use tax from California customers, because they conduct business only by mail order, but which have voluntarily registered with California for the purpose of collecting the tax. One of these companies annually collects over $1,100,000 in tax from California customers. Another collects each year in excess of $990,000 in tax. It is not surprising to us, however, that some interstate sellers previously free of reporting and compliance burdens find such burdens onerous. Yet this burden of compliance is a burden to which the local merchant is subjected without possibility of relief.

Since Willis was introduced in 1965, the system of sales and use taxation has had 15 years to mature. Both business and the states have had the opportunity to learn and to adapt. The solution to what problems may remain is not "more law." In so far as tax law is concerned, change rarely leads to simplification, the best of intentions notwithstanding. In the case before us, we are considering legislation to protect the few from the burdens placed upon almost the entire business community. As matters stand now, the purely mail er business is beyond the reach of the local taxing isdiction. This class of retailer already enjoys an antage over their local competitor which may be characterized inequitable. It must be kept in mind that we are talking ut a six percent competitive advantage available to the erstate seller over the local merchant. In many instances, s is the difference between profit and loss.

The Board asks that the sales and use tax provisions of S. 983 considered on their own merits separate and apart from the come tax provisions. In an era of "tax reform," when the ing system is under close public scrutiny and may be undering a restructuring, it is our view that any attempt to it the taxing base of the states should be predicated on re having been established a clear factual record of need. suggest that the need for action by the Congress in the ld of sales and use taxation is less than it was in 1965-- ce tax credit provisions have now been incorporated into ies and use tax laws, since no states now charge for the rformance of out-of-state audits, and since that certainty law which may have previously been lacking has developed rough practice and usage. We suggest that the compliance rden on the interstate seller has always been overstated-- evidenced by the Willis record and by our experience with luntary registration. The benefits to the public and to e economy, should the sales and use tax jurisdictional limits be adopted, are only problematical. The detriment to the local businessman from out-of-state competition is vividly apparent to those of us who work in the sales and use tax field on a daily basis. It is for these reasons that the California State Board of Equalization strongly opposes any federal legislation affecting sales and use tax, with the possible exception of extending the use tax collection jurisdiction to include mail order businesses.

There are certain provisions of S. 983 which are particularly objectionable. While agreeing with Section 101(a) of S. 983 which enacts the *Scripto* (solicitation) jurisdictional limit for purposes of *state* sales and use tax collection for periods *after* the enactment of S. 983, the Board strongly objects to the limitation of the *Scripto* case in Section 107 which forbids the assessment of a sales or use tax for periods *prior* to the enactment of S. 983, unless during those periods the out-of-state seller solicited sales by means of *employees* in the taxing state. Particularly when considered in light of Section 159, which defines when an employee shall be considered located in a state, Section 107 constitutes a windfall to those out-of-state sellers who avoid assessment of tax against them prior to the enactment of S. 983. Such sellers would, in effect, be rewarded for having ignored the decision of the U. S. Supreme Court 20 years ago in *Scripto*. During those 20 years, many out-of-state sellers have been collecting and remitting use tax to the states in which they regularly have salesmen, icitors, or representatives taking orders. Certain of ir competitors have instead avoided their responsibility the states whose market places they enjoy on a regular is. Yet S. 983 now proposes to reward the recalcitrant by roactively canceling the collection duty jurisdiction ounced in Scripto. There is no justification for such crimination against those who abided by the proper con- tutional standard. Rewards for tax evasion have no place federal legislation.

The second specific provision of S. 983 to which the rd particularly objects is Section 101(b) which tes the jurisdictional standard for a political subdivision unty or city) to impose a duty to collect local sales and taxes. Section 101(b) requires that, for solicitation to sufficient nexus, the solicitation must be by salesmen, icitors, or representatives in the political subdivision. sently, the presence of the person taking orders in the te is sufficient nexus for both state and local taxes and, as ted above, the Board collects both the state and the local by means of a single tax return.

Section 101(b) of S. 983 would mean that orders could taken by telephone from buyers throughout California, but out-of-state seller would not be required to collect local tax of any political subdivision other than the subdivision in which the salesman, solicitor, or representative was regularly present and from which he made the telephone calls. This provision would significantly reduce local tax revenues at a time when local governmental entities are financially hard pressed. If any change is to be made regarding local tax, it should be to accept statewide jurisdiction to require collection of a local use tax if the tax has a uniform rate and base and is state-administered.

The Board also disagrees with Sections 102(c) and 103 which exclude from the duty to collect use tax those sellers having less than $20,000 in taxable retail sales into California during the preceding calendar year or who sell to purchasers that are registered with the Board. This will complicate administration of the tax in that an out-of-state seller may have a collection duty in some years but not in others, with the taxing state unable to verify the seller's status except by an audit. The seller would still have to verify whether a given sale is taxable or not, as the cut off amount of $20,000 pertains only to taxable retail sales. More extensive audits of registered purchasers would be required to verify the reporting of use tax on purchases from such excluded out-of-state sellers.

The final two specific provisions of S. 983 on which the Board wishes to comment are Sections 104(e) which mandates a standard form of tax return to be prescribed by the Secretary of Commerce and Section 401 which gives the Federal Court of

aims jurisdiction to review anew any issues arising under
983. These provisions are nothing else but the camel's nose in
e tent, with a body of federal sales and use tax case law not far
hind. The quantity and quality of information available to
ate tax administrators from such a standard return form
uld be at the discretion of the Secretary of Commerce. The
ard's final decisions would go directly to the Court of
aims, which may or may not pay attention to the evolving
dy of state court case law on a specific state sales or use
x statute. There is no limitation of the Court of Claims'
risdiction to federal constitutional questions. It is not
nciful to envision a growing body of federal case law on
ch subjects as what constitutes a retail sale or an exempt
od product, with a divergent and long standing body of state
urt case law on the same subjects still in effect for
trastate sales.

The above comments only highlight some of the specific
asons for the Board's strong opposition to the sales and use
x provisions of S. 983. It is the Board's primary view
at, after all of the issues are weighed, the balance tips
avily towards the present system and against any Congressional
trusion whatsoever into sales and use taxation.

ted: June 20, 1980

D. D. Bell
Douglas D. Bell
Executive Secretary

STATEMENT SUBMITTED BY

KIRBY A. SCOTT

DIRECTOR OF TAXES

CAPITOL INDUSTRIES-EMI, INC.

HOLLYWOOD, CALIFORNIA

CAPITOL INDUSTRIES-EMI, Inc. ("Capitol") and its British parent, EMI Limited, ("EMI") now part of the Thorn EMI Ltd. group, have been directly and adversely affected by the system of unitary taxation as practiced by the Franchise Tax Board of the State of California. Regardless, however, of what taxing jurisdiction is involved, Capitol and EMI would find the unitary tax system equally offensive.

Capitol and EMI received firsthand experience with the inequities of the unitary tax system when California's Franchise Tax Board applied it to Capitol's 1971 fiscal year. In that year, Capitol's operations resulted in a taxable loss exceeding $13,000,000; however, after the Franchise Tax Board applied its brand of unitary tax apportionment with EMI, Capitol had net income of $3,464,000 and was faced with a proposed tax deficiency of $241,840. Capitol's concern can be better appreciated when it is considered that (1) Capitol is not engaged in any business which makes it unitary with EMI's Medical, Music and Technology businesses and, (2) the business conditions which caused Capitol's operating loss were peculiar to the United States.

Capitol and EMI support S. 1688 and believe it is legislation which is desperately needed.

The reasons why this legislation is necessary have been expounded by many scholars and practitioners in the tax world. We must accept responsibility adding our fair share to that literary effort in attempting to stop malignancy of that taxing system. For those reasons, this statement bbreviated and the incorporation of statements prepared previously epresentatives of Capitol and EMI in other hearings will suffice to g to the Committee's attention all the practical inequities these panies are experiencing at the hands of California's unitary tax inistrators.

The first statement attached contains the remarks by Mr. David B. mond before the California Assembly Revenue and Taxation Committee on ember 13, 1979 when he was speaking in favor of Assembly Bill 525 ch would limit unitary taxation in California. Mr. Hammond is now ancial & Commercial Director of EMI Entertainments Operations, but il recently was Group Taxation Manager of EMI and its world-wide sidiaries. In that position he dealt with many tax systems around world, so his remarks concerning the California Franchise Tax Board's inistration of the unitary tax as applied to Capitol and EMI should mulate this Committee's desire to approve S. 1688.

Mr. Hammond's remarks should also be significant to this Committee ause they are representative of the antagonistic feelings of many er British companies. Presumably they would represent the views of company in France, West Germany, Switzerland, Japan, etc. which has would like to have business operations in the United States.

The second attachment is a photocopy of the testimony, position paper and extension of testimony of Valentine Brookes, Esquire before the Senate Foreign Relations Committee when it held hearings in 1977 on the proposed United States-United Kingdom Tax Treaty. Mr. Brookes is a California lawyer who represented Capitol before the Committee and urged the adoption of the treaty with Article 9(4) which would have prohibited the application of the unitary tax system by the individual states with respect to a British parent.

The testimony of Mr. Brookes explains in some detail the businesses engaged in by Capitol and EMI and the arbitrary assessment proposed by the California Franchise Tax Board. Of course, Mr. Brookes's remarks were directed toward the necessity of a treaty to limit the individual states' power to apply the unitary tax to a British parent, but they are equally applicable to the need for passage of S. 1688 He points out that California, through the Franchise Tax Board, is "generally acting like a bull in the international china shop" and that such action "is unbecoming to the dignity of the United States, to the placidity of its relations with those countries with which it solemnly negotiates treaties, and accomplishes no purpose necessary for the protection of the revenues of the taxing States."

Mr. Brookes raises a significant point which is often overlooked in

iscussing the unitary tax system. He points out that the California
egislature does not mandate the world-wide application of the unitary
ax principle — that, in fact, the Legislature has not mandated the
se of the unitary system at all. What the Legislature did was to leave
he choice of the allocation method to the discretion of the Franchise
ax Board, and in its discretion the Franchise Tax Board decided to
ploy the unitary apportionment system universally, and, as the Board
rases it, "go world-wide" in its application by including foreign
arents, foreign subsidiaries, and foreign operations in those of the
xpayer. So at least with respect to California, S.1688 would not
persede a state statute; it would merely tie the hands of an administrative
ency and require it to collect taxes within the bounds of accepted
ternational tax rules. Mr. Brookes's remarks make for interesting
ading and should convince the Committee that S. 1688 must be passed.

In his testimony before the Senate Judiciary Committee on S.2173 in
cember, 1978, Mr. Brookes attempted to illustrate the differences between
erating abroad and operating in the United States. A copy of his
stimony and extension of testimony is also attached. He points out that
e unitary tax system ignores differences between United States economic
nditions and those prevailing elsewhere in the world and consequently
nores the varying profit margins which occur solely because of local
nditions in the various countries in which a group operates. The theory

of the unitary formula system can be equitably applied to operations within the United States. Labor and material costs, factories and equipment costs are generally similar, and the accounting books and records are maintained according to the same accounting system. Furthermore, they are maintained in the English language and in the same currency.

These conditions do not exist when the unitary tax is applied to foreign operations, especially in the case of a foreign parent which dictates the accounting system of its world-wide subsidiaries and, as it can rightly do, ignores the peculiar provincial requirements of California's Franchise Tax Board. Mr. Brookes's extension of testimony is an excellent summary of the mischief created by the Franchise Tax Board's application of the unitary tax system on a world-wide basis. He concludes that the unitary tax system should be regulated by Congress. And that purpose would be achieved by the passage of S. 1688.

Aside from the multifarious inequities of the unitary tax system when applied to foreign operations, there is another area of concern just beyond the horizon which should be considered by this Committee in its deliberations on S. 1688. To date, this area of concern is not an actuality, but it unquestionably will be a very real one if S. 1688 or similar legislation is not enacted.

I am referring to the inevitable retaliation by governments of states, rinces or other political subdivisions throughout the world if the cancer ated by California's Franchise Tax Board is allowed to continue and grow. s certain that if a provincial taxing jurisdiction in California is wed to reach outside its borders and, indeed, outside the United States, taxing jurisdictions of other political subdivisions in the countries und the world will retaliate with their own peculiar reporting requirements. example, the Province of Ontario in Canada, the State of Bavaria in West many, a Federal District in Mexico, or any political subdivision; indeed, list is endless, can each promulgate its own brand of a unitary tax ortionment system and apply it to a United States based company which an operation within that jurisdiction.

The present difficulties experienced by American companies in complying n the individual reporting requirements of the fifty states and hundreds cities will be insignificant compared to the spectacle of complying with ariety of unitary tax apportionment systems in political subdivisions of ntries all over the world. Obviously the compliance costs create itional operating expenses with no increase in productivity. The ultimate ult would be like the tower of Babel, only in this case, a confusion of tary tax systems. S. 1688 will relieve this anxiety; hopefully, it is too late.

REMARKS MADE BY

MR. D.E. HAMMOND

BEFORE

THE CALIFORNIA ASSEMBLY REVENUE AND TAXATION COMMITTEE

I am the Financial Director of EMI Film & Theatre Corporation - a member of the EMI Group of Companies whose parent company is EMI Limited, a company incorporated in England.

I am grateful for the opportunity of being able to speak in favour of Assembly Bill 525, particularly because EMI has experienced the practical inequities and onerous compliance requirements of unitary taxation. There is no fear of the unknown. This is reality.

EMI has several hundred reporting entities all over the world. It trades with more than one hundred countries and has subsidiaries in over thirty countries. It has subsidiaries with publicly owned minorities in several countries. EMI operates a TV station, theatres, studios, hotels, restaurants, bingo parlours, bowling alleys and squash racket clubs. It manufactures records, tapes, fire and theft prevention devices, technical products in various electronic industries, including the well known brain and body scanners. EMI finances, produces, distributes and exhibits motion pictures; it is engaged in defense contracts and research work of considerable secrecy. All in all, EMI is a very diverse organisation

One of EMI's subsidiaries is presently engaged in a dispute with the California Franchise Tax Board. That corporation is Capitol Industries which at the relevant time had publically held minorities and is principally engaged in the music business. One of the relevant years is a year in which Capitol made a significant loss while the remainder of the EMI Group was profitable. Because Capitol was unable to answer all of the questions of the California Franchise Tax Board, the Board sent to EMI in London instructions entitled "GUIDE FOR CORPORATIONS FILING A COMBINED REPORT". It starts by saying that -

The California franchise or income tax applies only to that portion of a Corporation's total net income, that is "derived from or attributable to sources within this State," and when a business which is conducted both within and without California, is unitary in nature, the portion of the business income from that unitary business attributable to sources within California must be determined by the formula apportionment.

It goes on to say that -

If a group of corporations conducts a unitary business the members of the group are required to report and compute the measure of the tax by what is called the "combined report" approach, and in determining whether or not the combined report approach must be used, the geographic locations of members of a unitary group is immaterial.

Does this mean that in order to compute Capitol's California source income it is necessary to combine 150 bingo parlours in the North of England with Capitol's music business, or a chain of steak houses in London, or a marina in a 60% controlled subsidiary in Sydney, Australia, or the activities of EMI in England as a result of its defense contracts with Her Majesty's Government?

We are also told that the combined report should contain, amongst many other things -

A combined Profit & Loss statement in columnar form, and
A combined apportionment formula in columnar form.

This creates major problems to an international corporate group such as EMI. The kinds of information required by California and the requirements as to the form in which it is required to be submitted place an immense burden on EMI that has no other reason to prepare such information.

Where members of the Group, and particularly the parent corporation, are located outside of the United States, much of this information is either difficult or impossible for the local taxpayer to obtain. Such information is not available to our U.S. subsidiaries. In some cases providing the required information would violate corporate policy or foreign laws, especially in relation to defense contracts, not only with the British Government but also with the Governments of other nations.

The required conversion of financial figures to dollars at scores of different rates of exchange with sharp fluctuations, devaluations and other changes, is an operational nightmare. California itself does not follow U.S. federal income tax accounting concepts. In fact the cost of compliance might conceivably be far in excess of the California tax itself. Further financial information may reflect confidential data, trade secrets or other important information that cannot be made available to governmental units having no connection with the companies involved. Indeed California's printed requirements are more onerous to EMI than the U.K. Inland Revenue, the U.S. Internal Revenue Service and even the Securities and Exchange Commission.

Some of the questions asked by the California Franchise Tax Board of EMI in London include -

a request for copies of agreements between EMI and its affiliates;

questions in relation to the reasons why EMI acquired Capitol and its affiliates;

demands for a summary of all inter-company charges between EMI, not Capitol, and its affiliates;

questions on how many trips were made by EMI personnel, not Capitol personnel, to its affiliates including names, dates, and business purposes.

Our local subsidiary would need to know the details of all of EMI's activities in order that it may be able to tell the California Franchise Tax Board enough to satisfy its curiosity. All of this is supposed to be necessary in order to find out how much of EMI's income is and I quote again "derived from or attributable to sources within this State" so that California can allocate income to Capitol and therefore tax it. It must be obvious that some of EMI's activities and income is none of California's business.

The basic rule applied in international tax law is that the profits of the various parts of an enterprise should be those which would result if the various parts were dealing with each other at arm's length. . .

Misallocation of the tax base under the application of unitary apportionment to foreign corporations will arise for several reasons. Labour costs vary more substantially among countries than among regions in the U.S. Similarly substantial differences in the cost of plant, equipment, inventory and other property, distorts the property factor. Such distortions are further increased by fluctuating currency conversion rates. If that were not enough the CTFB is not even consistent in its application of the three factor formula.

In the payroll factor the CTFB used a zero factor for EMI's 40,000 employees outside the U.S. Their interpretation of the property factor is also very questionable inasmuch that they included rented property only if it was located in the United States. All this positively favours the FTB.

The use of the unitary apportionment system is a highly imperfect substitute for the arm's length standard. Implicit in the unitary system is the assumption that profit rates in different units of a corporate family engaged in different activities at different locations are always the same. This is clearly not the case, and to that extent the unitary system will misallocate income. If an international group is involved these differences are likely to be accentuated compared with a domestic group. Furthermore, it is quite inequitable to fund a tax liability in an alien jurisdiction from a partly inaccessible profit source. Even if the concept of formula apportionment were acceptable, it does not recognise in our case the inability of Capitol to obtain restitution from EMI's affiliates in Australia, Brazil, France, Greece, India, Ireland, Italy, Japan, Nigeria, and many other smaller countries where exchange control and transfer pricing regulations exist.

To summarise, this extra-territorial extension of California taxing laws is a source of conflict and antagonism. It is reaching out for revenues which are not associated in any meaningful way with the State. It not only contains the danger that such arbitrary rules might be adopted by aggressive tax administrators in other territories, but also could erode the United States tax base on its corporations operation abroad. It imposes an onerous and in some instances impossible administrative burden in maintaining records under different foreign accounting practices in countries throughout the world just to conform with California tax accounting concepts.

For taxation purposes neither EMI nor any of its non-U.S. affiliates has a permanent establishment or taxable presence in California. This Bill will therefore relieve our local subsidiary of burdensome taxes and compliance costs on group income and it is for this reason that we support and sincerely hope that California will adopt AB 525.

2. With respect to those corps. to which French sells goods or from which it receives royalties. Why are these royalties paid? What percentage of the total food sales of these corps. results from the sale of products using materials or processes for which royalties are paid to French and what percentage of their total food sales result from sales of products purchased from French. What percentage of total sales of these corps. does food sales comprise? For control purposes please describe the lines of reporting of these corporations and the rest of the corporate group. Besides food sales what other activities do these corps. engage in? How are these activities integrated into the food sales? This last question should be viewed in terms of common distributors, marketing techniques, accounting, management, collections, credit and all other line and staff functions.

3. How are the worldwide operations of each product group coordinated? What are the policies concerning purity or quality of food products on a worldwide basis? How are these maintained or enforced? Please be very specific in how worldwide policies for each product group are developed, coordinated and enforced on a worldwide basis.

We would appreciate hearing from you as soon as possible. Thank you for your cooperation.

T. J. McAuliffe,
Auditor.

Senator Javits [Presiding]. Thank you.

Our next witness is Mr. Valentine Brookes.

STATEMENT OF VALENTINE BROOKES, BROOKES, BROOKES & VOGL, SAN FRANCISCO, CALIF., ON BEHALF OF EMI-CAPITOL RECORDS, INC.

Mr. Brookes. I am a California lawyer. I specialize in tax work. I am here to speak exclusively to the proposed article 9(4) in the proposed treaty.

I represent in California for tax matters Capitol Records, Inc. Its name describes or suggests what it does. It makes phonograph records and tape records primarily of music. It is owned entirely by a United Kingdom parent, EMI, Ltd. EMI has no permanent establishment in the United States, though it does own Capitol Records, a subsidiary which operates in the United States.

PRESENT CONTROVERSY WITH CALIFORNIA

For treaty purposes then EMI has no permanent establishment in the United States and is not present here. If the treaty is ratified in its proposed form for the future Capitol will be relieved of burdensome taxes on EMI's income. It has, however, a present controversy with California which I believe will not be affected by the ratification of the treaty and it gives light to some of the discussion that has been heard, particularly from the State representatives who have spoken in such glowing terms of the fairness and equity of the unitary system.

I think the committee might be interested in knowing more about how it actually does work in practice. This controversy with Capitol began with a demand from the Franchise Tax Board to EMI in London for a great many bits of information, quite searching questions coupled with the threat of a 25-percent penalty if EMI failed to respond. EMI did not respond.

A second letter from the Franchise Tax Board produced EMI's refusal to respond on the ground that the United States-United

Kingdom Treaty now in effect was with the United States and that included all 50 States and besides under regular concepts of international law California had no jurisdiction over EMI.

Thereafter, the Franchise Tax Board sent the same letter but with the designee changed to Capitol Records asking for the same information that it had asked of EMI and again with the threat of a 25-percent penalty if the answer was not given in full.

Capitol asked EMI for some help. EMI replied that much of the information that was sought was beyond its own knowledge, it could not assemble it. In the second place, it said "We are governed by British law and we cannot disclose this to you under British law."

The next step was a proposed arbitrary assessment against Capitol. Capitol has protested it and this is where the matter stands at the present time except for some further correspondence between my client and EMI, again pleading for help.

EMI this time has cited the Official Secrets Act which it says it would violate if it gave Capitol this information so that Capitol could give it to a political subdivision of a foreign power. It says that it will not be blackmailed by a threat of arbitrary assessment into the violation of the U.K. Official Secrets Act.

EMI OPERATIONS

Now, a bit more about EMI. EMI not only makes phonograph records and tape records and sells them to subsidiaries; it makes them in the United Kingdom. Through subsidiaries it makes them in Holland and France, Italy and the United States. In addition, it operated the only London privately owned television station in competition with BBC. It operates theaters and studios in which movies are made. It operates hotels, mostly on rented premises. It even operates bingo parlors in the United Kingdom. It manufactures theft prevention devices and sells them throughout the world. It manufactures technical products in the electric industries and electronics industries. EMI takes credit for having developed the airborne radar which was on the aircraft that the British pilots flew in the Battle of Britain. This has kept it deep in British defense work ever since.

It makes and sells throughout the world the brain scanner which is so well known in the United States today and for which it last year won the Queen's Award.

Its defense work in general terms goes into a continued application of radar for aircraft and ships, fighting vessels, proximity fuses, sensing devices, mortar detectors and search vehicles both airborne and waterborne.

Then it engages in research work of considerable secrecy for the United Kingdom, both that which becomes part of products it manufactures and of those manufactured by the Defense Department for Britain, itself, and others.

CAPITOL'S NEED FOR DETAILS

Capitol would need to know the details of all of these enterprises including these military application enterprises in order that Capitol may be able to tell the California franchise tax board enough to satisfy its curiosity.

Now, all of this is supposed to be necessary in order that California can find out how much of EMI's income it should allocate to Capitol and tax. It should be obvious that some of EMI's income, all of it from operations not involving phonograph records, are none of California's business since none of that operation by EMI is even in the United States. Neither EMI nor Capitol can possibly tell the State of California the details about the research which it does for the British Defense Department or other things that would represent a violation of the Official Secrets Act.

WHAT IS TO BE DONE?

Now, if the United Kingdom itself is not satisfied with this state of affairs involving whipsawing of one of its industries between the British law and the California law, what is it to do?

There has been some suggestion that the United Kingdom should not invoke the treaty procedure. But, it has no representatives in the California Legislature or in Congress and of late there has been considerable expression of concern by the Congress over the propriety of foreign governments lobbying their own positions before the Congress.

So if it has withheld this sort of activity from the Congress it should not be criticized. I think the Senators will agree. It can do as normally foreign governments do in dealing with the United States, enter into a treaty.

Now, there has been a suggestion that there should not be a treaty with the United States but instead with California and another treaty with Oregon and one with Alaska and then with every State which successively may invoke this system of putting foreign income into the unitary group. I do not believe that the Senate of the United States is the place to make the suggestion that foreign powers should engage in making treaties with States.

So far that has been thought to be unconstitutional and hasn't been attempted by foreign countries.

The final alternative suggested indirectly by a preceding witness is that the U.K. enterprises can withdraw operations from the United States. This is a Draconian result which I am sure that the Senate will not suggest is proper. There has been reference also to the impropriety of making what one of the witnesses this morning from my State called an end run around the Congress. The entire treaty-making process, as one of the Senators remarked, could be regarded as doing that very thing.

Let me dwell upon the rest of what this treaty involves as well as every preceding tax treaty. The rest of the treaty and all prior treaties involve only limitation from Federal taxes or something related to Federal taxes.

In the imposition of Federal taxes the House of Representatives has the constitutional power of initiation. If its sensitivities are great on this subject it should, I suppose, be more sensitive about having the power of initiation on Federal taxes taken away from it than having some limited jurisdiction over State taxes taken away from it.

So, it is difficult for me to conceive of how there can be any appropriate suggestion that in this particular area where the House of Representatives normally does not legislate anyway, the treaty process should not be invoked to limit the States.

RESPONSE TO PRECEDING WITNESSES

Senators, I have much to say in response to other things that have been stated by the preceding witnesses of the last day and a half.

I understand that the record will be kept open for enlargement of remarks. If this may be so, I should like to utilize that method of answering some of the other things that I have deferred.

Senator CHURCH. Certainly. The record will be kept open for that purpose.

[Mr. Brooke's prepared statement and enlargement of remarks follow:]

POSITION PAPER OF VALENTINE BROOKES, ESQ. ON PROPOSED U.S.-U.K. INCOME TAX CONVENTION, PARTICULAR REFERENCE TO LIMITATION OF THE POWER OF THE STATES TO TAX

This Position Paper is in support of the position that the section of the proposed U.S.-U.K. Income Tax Convention limiting the power of the States to include U.K. enterprises in allocation formulae of corporations doing business in the United States should be ratified, with the protocol which has since been negotiated as an amendment to the treaty. If any changes be made prior to ratification, the change which this position paper recommends is the elimination of the protocol.

The treaty as originally signed limited the power of the States to include any U.K. enterprise in a unitary group for allocation purposes without regard to whether it was owned by residents of the U.K. or by American interests. Apparently in an effort to mollify the States opposing that provision in the treaty, a protocol was later agreed to limiting the restrictions on State power to tax to those U.K. enterprises which are owned by U.K. residents. The protocol has not had the effect of inducing the States to refrain from opposing the treaty, and since the protocol discriminates against American-owned business doing business in the U.K. and in favor of U.K.-owned business, there seems to be no purpose of American foreign policy in continuing to accept the limitation on the restriction the protocol represents. Nevertheless, if the world has turned on its axis so far that the protocol has become imbedded in the treaty irrevocably, this position paper urges ratification of the treaty with the protocol, rather than its rejection.

The principal opponent of the treaty is the State which has been most ardent in its application of the unitary theory of allocation of net income on a worldwide basis, which is the State of California. Much of the discussion herein will therefore be of the position of the taxing agency of that State, and of the Courts of that State.

First, it appears quite possible that the California Supreme Court would hold that under some circumstances the existing U.S.-U.K. income tax convention would prohibit the inclusion of U.K. enterprises in the unitary group California would create for its taxing power. In *Scandinavian Airline System, Inc. v. County of Los Angeles*, (1961) 56 Cal. 2d 11, 14 Cal. Rptr. 25, 363 P. 2d 25, cert. den. 368 U.S. 899, the California Supreme Court held that the County of Los Angeles could not tax the airplanes of SAS because of the income tax conventions in effect between Sweden and the United States. From the opinion it appears that each of the three foreign countries owned one or more of the airplanes operating between Copenhagen and Los Angeles. Los Angeles County attempted to tax an apportioned amount of the value of each of the airplanes. The Swedish treaty contained a provision which the California Supreme Court interpreted as applying to local property taxes of Sweden, and which it considered would have prevented the Swedish local governments from taxing the property of an American enterprise in reverse circumstances. It therefore co cluded that the Swedish airplane was exempt from State taxation on reciprocal principles it found in the treaty. It concluded also that in spite of the lack of parallel provisions in the Norwegian and Danish income tax treaties with the United States, those countries were entitled to the benefits of a most favored nation clause it found in each of their treaties, and hence they enjoyed the same exemptions for their airplanes which the Swedish airplane was found to enjoy. The Court went further and held, as an alternative ground (14 Cal. Rptr. at 43) that federal constitutional provisions prevented California from discriminating between foreign nations, and therefore it must accord each nation the favored treatment the Swedish treaty provided for the Swedish property. The California Supreme Court summarized its conclusions by stating:

"This is but another way of saying, as we have said above, that taxation of foreign owned and based instruments of commerce represent a field that is peculiarly federal in nature, without regard to such specific constitutional considerations as the commerce clause or the due process clause, and which must be left to the administration of the federal government, even in the absence of any present federal legislation thereon."

One would suppose that the California Supreme Court would voice the same views in an income tax case, since the tax treaties it construed were income tax treaties, except for one minor provision in the Swedish treaty. It appears quite possible, accordingly, that California's own Supreme Court would hold that under at least some circumstances the existing treaty limits California more broadly than the proposed treaty with the protocol added.

The California Supreme Court's decision in the *SAS* case was by a divided Court. Both of the dissenting justices have since left the Court. A treaty case is pending before the Court now and the Court will have the opportunity to decide whether to continue to apply the *SAS* case, or to extend it further, or to limit it. Until the case now before it has been decided, one must assume that the *SAS* decision continues to represent the views of that Court. In assessing the significance of the opposition of the California taxing agencies to the proposed treaty, therefore, one must reckon with the distinct possibility that the highest court of California would hold that under existing treaties California cannot constitutionally do what its tax agency contends it is doing consistently.

Moreover, the only California appellate decision which has involved the California tax authorities' attempts to go worldwide in their consolidation and unitary formula theories is directly opposed to the tax agency's position. It rejected their position completely. That decision is *Chase Brass and Copper Corporation v. Franchise Tax Board*, 7 Cal. App. 3d 90, 86 Cal. Rptr. 350; 10 Cal. App. 3d 496, 87 Cal. Rptr. 239; 95 Cal Rptr. 805. On the issues the Franchise Tax Board lost, no hearing was sought in the California Supreme Court, so the decision has become final on those issues, although it continues actively in the Courts on the issues on which Chase lost. The case involved the effort by the Franchise Tax Board to consolidate Kennecott Copper Corporation and all of its subsidiaries with Chase Brass and Copper Corporation, which was entirely owned by it. Among those other subsidiaries was Braden Copper Corporation, a Maine corporation which operated exclusively in Chile. In that country it owned and operated a copper mine, smelter, and refinery. In the taxable years, a considerable portion of the refined copper of Braden was sold by Kennecott in the United States, but ordinarily Braden copper was sold in European and Asiatic markets, not in the United States. Both Kennecott and Braden conducted, generally, the same type of copper business. The Court sustained the consolidation of Chase with Kennecott's copper business and the application of the allocation formula to the combined copper net income of the two corporations, but it held that Braden was not part of that unitary business, because Braden conducted its copper business in a foreign country and not in the United States. The California tax authorities consistently cite the *Chase Brass* decision as authority for the consolidation of various commonly owned corporations conducting a domestic business, but with equal consistency reject the possibility that any portion of the decision which is adverse to any of their other contentions is of the slightest precedential significance. Hence, they ignore the *Braden Copper* aspect of the decision, and the defeat to their position which it represents. But if the other California Courts follow that decision, the California Franchise Tax Board will be prevented by their own Courts, on local statutory and constitutional bases, from going worldwide. In that event, the treaty will deny them nothing which their own Courts would permit them to have.

The author of this Position Paper was the attorney who represented Chase Brass in the foregoing case, and he also represents a number of other taxpayers in litigation now pending in California Courts and administrative agencies, in which he is urging upon the California Courts that they follow the Braden Copper aspect of the *Chase Brass* case. Other attorneys are doing the same with their clients. It is possible that in at least some of the pending cases the issue will be decided the same way it was in the Braden Copper instance, and California will lose in its own Courts, with the consequent necessity of making large refunds of taxes already collected. This will represent a fiscal burden to the State of California greater than any threatened by the treaty under consideration, because the California procedure does not permit a taxpayer to litigate a tax without first paying it. In consequence, every defeat the State suffers in its own Courts will result in a refund of taxes already paid into the State Treasury. The doubtful wisdom of a tax administration which is so suspect constitutionally and so stoutly resisted by taxpayers which may cause such gigantic drains on the State Treasury, through successful suits for refunds, would justify the Senate in questioning the wisdom of the advice that tax administration is giving it.

The *Chase Brass* case, involving Braden Copper Corporation, rejected California's attempt to consolidate and allocate by formula where the parent corporation was a U.S. corporation. Notwithstanding its defeat in those circumstances, the Franchise Tax Board has resolutely attempted to assert its sway over foreign parent corporations having U.S. subsidiaries which operate in California. One is reminded of Don Quixote. One of these is a client of the author of this paper, who has been given permission to reveal some of the facts presented in its case. The client is Capitol Industries–EMI, Inc., the stock of which is owned by a U.K. company, EMI Limited, which has operations directly or through subsidiaries in thirty-three countries. Capitol Industries is better known as Capitol Records. It records musical performances and spoken performances in the United States, makes phonograph and tape records from the tape masters of the performances, and sells the records to the public through distributors. Its specialty is pop and country music. It has a long-standing reciprocal licensing arrangement with EMI, under which masters of all of its recordings are available to EMI for the making of phonograph records for sale in the United Kingdom and Europe, and certain other countries, and in return EMI makes its classical repertoire available to Capitol, which presses records from it in this country and markets them under the names Angel and Seraphim. The arrangements clearly are of the type to be examined by the Internal Revenue Service under Section 482, Internal Revenue Code, and this examination has routinely occurred. The terms of the reciprocal arrangement have been in effect for twenty years and the working out of those arrangements has not been challenged in repeated audits under the Internal Revenue Code over that period. The State of California and the other states in which this corporation does business and to which it must pay taxes enjoy the benefits of the examination by the Internal Revenue Service, and if any unfairness to the United States in that reciprocal arrangement were uncovered by the Internal Revenue Service, each of those states would benefit accordingly, through parallel adjustments to the total U.S. income of the corporation.

This does not, however, satisfy California. It wants to force EMI Limited and Capitol into a consolidated unit, notwithstanding that EMI has numerous businesses of a type entirely foreign to and different from the record business of Capitol Records. For example, EMI Limited controls a television station in the U.K., which is the largest privately owned television station in that country; it owns and operates movie studios and a chain of cinemas; it owns and operates hotels and restaurants; it operates in the electronics field and has succeeded in developing the famed EMI brain scanner, which is being sold in the United States through another EMI subsidiary, which the Franchise Tax Board would consolidate with Capitol Records; it is a significant U.K. defense contractor. Under U.K. Law it would be guilty of treason as well as lesser offenses if it revealed any details, financial or otherwise, of those contracts to a political subdivision of a foreign power. The only unity which can exist between a U.K. defense contractor and an American phonograph record company, and between an American corporation which sells x-ray brain scanners and a subsidiary which makes and markets phonograph records, is unity of ownership. The Franchise Tax Board's theories of unity have now been reduced to where one unity is sufficient, if that one be unity of ownership.

The Franchise Tax Board wrote EMI in London asking that it make available to the Franchise Tax Board the type of all-revealing financial information it is accustomed to obtaining from taxpayers operating in California and other states. EMI replied to the Franchise Tax Board that the requested information was confidential and its revelation would be harmful to its interest; it pointed out that it had no permanent establishment in the United States and would no be expected to make such revelations to the U.S. tax authorities; it stated also that much of the information was not available to it, because it was not of the type which a British taxpayer would need and would accumulate; and finally, it stated that under both international law and the existing U.S.-U.K. treaty it was not amenable to the jurisdiction of the State of California and would not provide it with the requested information. The Franchise Tax Board asked Capitol Industries-EMI, Inc. to provide it with that information, and a letter from the American subsidiary to EMI Limited in London also failed to produce the information, the reasons given by the parent corporation to the request of the subsidiary being a reference to the refusal it had made when asked for the information directly by the Franchise Tax Board. The Franchise Tax Board then wrote both EMI and Capitol, threatening penalties if the demand for information was not complied with. Fortunately for all parties, sanity has subsequently prevailed with the Franchise Tax Board to the limited extent that the subsequently proposed assessment against Capitol did not assert penalties against it for its failure to force its parent corporation to accede to something the parent corporation had refused to do. The Franchise Tax Board has, however, issued a proposed assessment against Capitol Industries-EMI, Inc. without complying with the California statute which requires that the Franchise Tax Board supply the taxpayer, on request, with the details of the computation of allocated net income. Although Capitol has written the Franchise Tax Board asking that those details be supplied to it, the request has not yet been complied with. From the process of working backwards from the proposed assessment to the figures which are known to Capitol, which are the U.S. figures and those available in EMI's published reports, it appears that in the payroll factor the Franchise Tax Board has used a zero payroll figure for EMI's operations, although EMI's published reports reveal that it had more than 40,000 employees worldwide, and also revealed the payrolls in the U.K. The omission has the necessary mathematical effect of multiplying the percentage of the consolidated income which is allocated to California. Also, it appears that the property factor is improperly weighted in favor of California, apparently because rented property was included in the property factor only if it was located in the United States. A protest has been filed against this assessment, and undoubtedly Capitol will, in due course, learn the secret of the Franchise Tax Board's mathematics, but Capitol fully expects to learn that the Franchise Tax Board has taken the position that since EMI has been unable or unwilling to tell it what its worldwide payroll is, then it must be treated as having 40,000 employees work for nothing.

The response of EMI to the California demand for information may interest the Committee. The response was that the treaty between the United Kingdom and the United States binds each of the United States, whether taxing as a single state or as a national united government. This states the position the Senate should take, as the proposed treaty does: a commitment made by the United States should not be undermined by the individual States. The United States should consider what its own attitude would be if the United Kingdom should permit a local government with taxing power to be formed in Scotland and in Wales and should assert that the treaty limitations on the taxing power of the United Kingdom did not limit taxation by the government of Scotland or that of Wales. The United States would inevitably consider, we suggest, that the treaty had not been entered into in good faith in the first place if it could be so undermined.

On solid principles of international relations, the States should not be permitted to extend their reach to foreign countries in circumstances in which the United States by treaty has agreed not to extend its own. The spectacle of any State, and there are fifty of them that could do so, if permitted, demanding of a U.K.-based corporation doing no business in the United States that it make as complete a revelation of its internal financial affairs as it must to the United Kingdom government, is distinctly unbecoming. It is a burden on foreign commerce, and an affront to the dignity of the United States. For California or any other State to contend that burdensome demands for information and breach of confidentiality are necessary in order that the State protect its taxation interest, when the United States government does not find it necessary to do likewise, stretches credulity beyond the breaking point. While each State is entitled to have its own concept of proper taxation and revenue administration, that is only within the confines of its own jurisdiction. Manifestly it has no jurisdiction to force EMI Limited to do anything at all. Its only hope is to resort to the subterfuge of imposing a tax on EMI's subsidiary which will be so heavy that EMI will find itself economically compelled to accede to the California demand. This is precisely what California is attempting to accomplish. Yet one cannot accept as being serious a contention that California must know the financial secrets of EMI's brain scan invention, and of its ability to operate a private television network in the United Kingdom in the face of the competition of BBC, or the cost and profits from defense sales to the Government of the United Kingdom, in order that California may determine how much net income Capitol Records makes in California from making and selling phonograph records.

In summary, forcing U.K.-based companies to reveal their financial secrets to the State of California is unnecessary to permit California fairly to enforce its tax laws. The Internal Revenue Service faces a similar problem, deals with it successfully, and makes the benefits of its operations available to California to apply for its own protection. California and the other States are all alike in this respect. None of them needs more protection than they already have, by virtue of the administration of Section 482 of the Internal Revenue Code by the Internal Revenue Service. To permit them also to roam the world threatening U.K.-based companies having no permanent establishment in the United States, demanding information which the United States would have no treaty right to demand, and generally acting like a bull in the international china shop, is unbecoming to the dignity of the United States, to the placidity of its relations with those countries with which it solemnly negotiates treaties, and accomplishes no purpose necessary for the protection of the revenues of the taxing States. If the treaty is objectionable in any respect, it is in the limitations of the protocol. It should be ratified, preferably without the protocol, but better with the protocol than not at all.

Finally, a comment should be made about Governor Brown's letter to Senator Sparkman. It is unlikely that the Governor is informed about the California court decisions discussed in this paper. They are obstacles in the way of the California tax authorities' efforts to force worldwide consolidation and apportionment on the portion of the world's business which has subsidiary operations in California. Until those obstacles are overcome, California's representatives are in the position of asking the Senate to let them persist in an effort to tax foreign income arbitrarily apportioned to California by an entirely mathematical formula, an effort their own Courts may well hold is violative of the United States Constitution.

EXTENSION OF TESTIMONY OF VALENTINE BROOKES, ESQUIRE BEFORE SENATE FOREIGN RELATIONS COMMITTEE ON ARTICLE 9(4) OF PROPOSED U.S.-U.K. INCOME TAX TREATY

Because of the necessary limitation on the time of the witnesses, some testimony which would have been given in response to the testimony of preceding witnesses had to be eliminated from the testimony of Valentine Brookes. Pursuant to permission granted by the presiding Senator, this extension of remarks is submitted.

1. Contrary to the statement of a witness representing the State Government of California, the California Legislature has not mandated the world-wide application of the unitary principal. In fact, the Legislature has not mandated the world-wide application of the unitary principal. In fact, the Legislature has not mandated the use of the unitary system at all. What the Legislature has done is to leave the choice of allocation method to the discretion of the Franchise Tax Board, and in its discretion the Franchise Tax Board has decided to employ the unitary apportionment system universally, and to go worldwide in its application. The phrase "worldwide" has been coined by the Franchise Tax Board, and means including foreign parents, foreign subsidiaries, and foreign operations of the taxpayer, as to net income and as to property, payroll and sales, in the net income to be allocated and in the factors used for apportionment. California has adopted the Uniform Division of Net Income For Tax Purposes Act, which is in effect in a majority of the states using the unitary

system. Its language in this respect is not different from the language adopted by the Legislatures of those states whose administrators have not construed it to go worldwide. It is as follows:

"§ 25101: Basis of allocation. When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120 of this chapter); provided, however, that any method of apportionment shall take into account as income derived from or attributable to sources without the state, income derived from or attributable to transportation by sea or air without the state, whether or not such transportation is located in or subject to the jurisdiction of any other state, the United States or any foreign country.

"If the Franchise Tax Board reapportions net income upon its examination of any return, it shall, upon the written request of the taxpayer, disclose to it the basis upon which its reapportionment has been made."

"§ 25121: Application. Any taxpayer having income from business activity which is taxable both within and without this state shall allocate and apportion its net income as provided in this act."

"§ 25128: Business income. All business shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three."

"§ 24137: Other apportionment methods. If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable: (a) Separate accounting; (b) The exclusion of any one or more of the factors: (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

The Senate will observe the absence of any provision requiring that the several corporations be combined, and all reference to foreign operations is omitted. Concerning the consolidated report, the Statute says:

"§ 25104: In the case of a corporation liable to report under this part owning or controlling, either directly or indirectly, another corporation, or other corporations, and in the case of a corporation liable to report under this part and owned or controlled, either directly or indirectly, by another corporation, the Franchise Tax Board may require a consolidated report showing the combined net income or such other facts as it deems necessary. The Franchise Tax Board is authorized and empowered; in such manner as it may determine, to assess the tax against either of the corporations whose net income is involved in the report upon the basis of the combined entire net income and such other manner as it shall determine to be equitable if it determines it to be necessary in order to prevent evasion of taxes or to clearly reflect the net income earned by said corporation or corporations from business done in this State."

Again the Senate will note the use of the word "may", which in the English language is understood to confer discretion and not a mandate.

2. Controller Cory stated that all of the cases on the subject sustained the inclusion of foreign operations in the unitary group. There are only two cases on this subject in the California Appellate Courts, and both are contrary to Controller Cory's statement. They are the Scandinavian Airlines case and the Chase Brass case, both cited in my position paper. The former case was discussed at length by Secretary Woodworth.

3. Article 9(4) is reciprocal, whereas legislation adopted by the Congress would not be. A legislative limitation on the states comparable to Article 9(4) would bind the states, but would not prevent foreign governments from permitting their political subdivisions to adopt identical methods of taxing American businesses operating in other countries through subsidiaries having permanent establishments there. The treaty route binds the other countries, and this can be of particular importance in those countries having a federal system. Among countries already having such a system are West Germany, Australia, Canada, Brazil, and Mexico. There is a parliamentary discussion of the adoption of some limited federal system in the United Kingdom, which might give Scotland, for example, a power of taxation, and that power, if conferred by the Parliament on Scotland, would be subject to the limitation of Article 9(4).

The United States, therefore, gains an important objective by having the provision adopted by the medium of the treaty, instead of pressing for legislation which would be exclusively unilateral in its limitations.

4. The states are utterly without constitutional support in contending that the treaty represents a "federal intrusion" into their sovereignty. The states are were political subdivisions of the United States, and in the exercise of their limited sovereignty are subject to the following federal powers germaine to taxation: (1) The interstate commerce clause, which imposes limitations on state powers which in practice are administered exclusively by one branch of government, namely the Judiciary through the United States Supreme Court; the Constitution and the Court both recognize that Congress has the power to regulate commerce and any regulation it adopts supercedes any Court decision; failing legislation, which is the norm, the Supreme Court has adopted a set of rules unilaterally. (2) The foreign commerce clause, which is adjunctive to the interstate commerce power, and may be articulated and enforced by the Supreme Court, the Congress, and also the Executive with the advice and consent of the Senate, through the treaty power. (3) The due process clause, which is customarily enforced by the Supreme Court, but has been, as it may be, also interpreted and enforced by statute.

It is therefore apparent that constitutional restriction on the powers of the states have been more often interpreted and enforced by a single branch, the Judiciary, than by any other branch of government, whereas in the treaty making power the limitation is the joint product of the Executive arm and the legislative arm. The complaint of the states that there should be no "federal intrusion" on their power without the acquiescence of the House of Representatives is seen, therefore, to be an argument of desperation and without any merit. Finally, I referred in my testimony to the inappropriateness of any suggestion that a foreign nation should seek to make a treaty not with the United States but with the states in order to obtain limitations on their taxing structure, and I stated that such conduct had previously been thought to be unconstitutional. I did not cite the constitutional reference. Article I, Section 10, Clause 1 of the United States Constitution states:

"No State shall enter into any treaty * * *"

5. In my position paper I stated that the protocol limiting Article 9(1) to U.K. parent corporations, and omitting U.K. enterprises to which Article 9(4) would apply to those owned by U.K. shareholders, was in response to the objections of the states to the original provision. During their testimony, the representatives of the states were consistent and unanimous that they had not heard about the treaty before it reached the Senate, at which time that protocol had already been added. I therefore erred in stating that the protocol was in response to the objections of the states. Seemingly it was caused by the Treasury's own analysis, and was not placed in the exchange of notes in order to placate the American states. It certainly has not had that effect. If the Senate were to reserve, it therefore has even more reason for making its reservations against the protocol instead of Article 9(4). However, in view of the testimony of Secretary Woodworth about the probable effect of any reservation on action by the British Parliament, I do not urge the Senate to make any reservation at all.

I appreciate the opportunity of filing this extension of remarks, and urge the ratification of the treaty, without reservation.

Respectfully,

VALENTINE BROOKES.

Senator CHURCH. Our next witness is Charles M. Walker, who appears on behalf of himself, former Assistant Secretary of the Treasury for Tax Policy, Los Angeles, Calif.

STATEMENT OF CHARLES M. WALKER, FORMER ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. WALKER. Thank you, Mr. Chairman.

I am pleased to appear to testify in support of the new United Kingdom Tax Treaty.

Between Developed and Developing Countries prepared in 1974 by a special group within the United Nations also adopted the separate accounting method.

State representatives who advocate the unitary method have complained about the complexity of using the arm's-length standards of section 482 in determining pricing for intercompany transactions. They have complained that the States simply do not have the staff of international specialists such as those employed by the IRS in reviewing intercompany transactions. A substantial answer to this complaint is that the IRS regularly audits most major multinationals operating in the United States and the results of these audits are available to the States. Testimony of Laurence N. Woodworth, Hearings, 34. Furthermore the unitary method does not answer all intercompany pricing problems because even under a very broad definition of a unitary group certainly not all affiliates will be unitary. Therefore the States will have to make some computations under the State equivalent of section 482, or utilize those made by the IRS. In addition, this paper and those of other panel members illustrate that making a determination of apportionable income under the unitary method is not simple. Indeed the problems are as complex as those encountered under section 482, if not more so. Thus it would appear that State tax administrators would find it easier to resolve problems under section 482 with the substantial help of the IRS than attempt the complex problems arising under the unitary method without any help at all.

A comment should also be made in regard to complaints of losing State revenue. The California Franchise Tax Board, in particular, has complained about a loss of revenue if the State is not permitted to use the unitary method in the international area. Although there are disputes between Governor Brown, the franchise tax board and taxpayers about the accuracy of the amount of such revenue loss, the fact is the franchise tax board can hardly complain about lost revenue until the courts have determined the cases brought by taxpayers challenging the authority of California to impose the system upon multinational corporate groups. Furthermore, the franchise tax board insists on apportioning the income of multinational groups by the property, payroll and sales factors without adjustment for variations in the factors and for greater profitability as between countries. Thus it is quite possible that much of the lost revenue claimed by the board results from apportioning the income of foreign corporations to California that has already been taxed by the countries where the corporations operate. Thus the franchise tax board is complaining about its inability to tax the income twice. It should also be noted that California does not allow a foreign tax credit or deduction for income taxes paid to foreign countries. Thus the revenue bite in California is based on including the total foreign net income before taxes which may be as high as 50–60 percent of net income.

III. CONCLUSION

It is clear that the unitary method as administered by the California Franchise Tax Board, its leading exponent, is not workable in the international arena. The assumptions underlying the method that each member is operating in a common market which is without substantial differences in economic, political and social conditions and which permits an equal return on the factors do not exist on a worldwide basis. As a result of variations in the factors and of profitability between different countries, foreign source income is frequently apportioned to California and other states imposing the unitary method. Because other countries have adopted the separate accounting method which localizes profitability in separate countries, double taxation is inevitable.

There is, however, a more basic reason why States should be prohibited from adopting the unitary method on a worldwide basis. That is because it seriously disrupts efforts to achieve uniformity in taxing commerce among the countries of the world. The separate accounting and unitary methods are obviously antithetical. They are based upon different assumptions, apportion income differently, require the keeping of different records, and require different factual determinations for their implementation. Uniformity is impossible if two divergent methods of apportioning income are to be imposed upon multinational corporate groups by the United States and foreign countries on the one hand, and by the States on the other. It should be noted that insofar as various States adopt the unitary method, there is not only a lack of uniformity between those States and the United States and foreign countries but there is the probability of a lack of uniformity between the States themselves in defining the elements of the unitary method.

The debate in regard to the merits of the separate accounting method or the unitary method in the multinational area is interesting, but beside the point. As Professor T. S. Adams stated many years ago about State taxation of interstate commerce: "What is most needed is a uniform rule. Just what rule shall be selected is less important than the general adoption of the same rule by competing jurisdictions." [4]

The United States and its foreign trading partners have adopted separate accounting as a uniform apportionment rule. It makes little sense for the States of this country to embark upon an entirely different apportionment rule. The only workable solution to the problem is for Congress to prohibit the states from adopting the unitary method in apportioning the income of multinational corporate groups.

PREPARED STATEMENT OF VALENTINE BROOKES

INTRODUCTORY

These remarks are directed at the California system of apportioning net income to California, where the taxpayer is part of a commonly owned corporate group which operates throughout the United States and other parts of the world. The California system is to disregard the corporate entities of the several corporations in computing the net income and the amount of the factors to be employed, so a consolidated group net income is created, and a consolidated apportionment factor is devised in which the ratio of California property to world-wide property, California payroll to world-wide payroll, and California sales to worldwide sales, is employed. The net income is multiplied by the average of the California percentage of the three factors and the resultant figure seems to be income derived from or attributable to California, which California proceeds to tax. Technically the California tax is on the franchise of whichever member or members of the corporate group do business within California, measured by that net income, but the practical effect is the same as if the tax were directly on the net income. In the remarks hereafter no distinction will be made between a direct tax on net income and a franchise tax measured by that net income.

A. The unitary system as described above ignores differences between United States economic conditions and those prevailing elsewhere in the world, and these ignored distinctions are critical. Ignoring them necessarily produces distortion, so that the income attributed by the formula to California will be either more or less than it should be, and only by a miraculous coincidence will it be the proper one.

1. The most obvious vice in the California system is that it ignores the varying profit margins which occur solely because of local conditions in the various countries in which the group operates. The mark-up (percentage of gross profit) is usually higher in other countries than it is in the United States. This tendency is attributable to different circumstances: first, the business done in less developed nations, including the so-called Third World nations, involves a great political hazard, so that the business will not venture into such an area unless it can hope to get its investment returned to it more quickly than in a more predictable political environment, and necessarily that requires a larger margin of profit; much of the business done in the developed countries is done in an environment in which intense competition such as that which is required by law in the United States is actively discouraged, with the result that the marketplace tolerates a larger margin of gross profit than is customary in the United States.

Labor costs are frequently substantially lower in foreign countries than in the United States, although within the last 2 or 3 years inflation abroad has progressed more rapidly than in the United States and has tended to close that gap. Also, hours of work tend to be longer outside the United States than within it.

For these reasons, the productivity of labor abroad cannot be accurately measured by wages paid when those wages are then compared to wages paid in the United States. More often than not the wage differential will permit a greater margin of net profit abroad than in the United States, but the effect of the wage factor in the three-factor formula is not merely to ignore that difference, but to reverse it; the lower the wages abroad the smaller the weight they have in the payroll factor, and the larger the drawing power of the higher United States wage factor is in pulling net income into the United States, by the operation of the percentage formula.

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[4] Quoted from Hellerstein, supra, 21 Nat. Tax J. at 483.

Finally, material costs are often less abroad than in the United States, which in combination with the lower labor costs permits the selling price of similar articles to be less abroad than in the United States but yet produce a larger margin of profit. The effect of the formula, however, in apportioning net income according to the relationship between sales, is to depress the net income apportioned to the foreign countries where the dollar volume of sales is less and increase the percentage allocated to the United States and hence California, even though in fact the potential of the sales to produce net income is greater abroad.

Finally, factories and their equipment are often less expensive abroad than in the United States, and in the property factor income is apportioned according to the relationship between the cost of factories in the United States and the cost of factories abroad. An equally efficient plant in Italy will usually cost less than its corresponding one in the United States, but will be deemed to be less productive of net income by the operation of the formula simply because it costs less in United States dollars.

2. Another flaw in the unitary concept is that it assumes that the same products sold in the United States are those which are sold by the group throughout the world. To state an extreme example of the point that is being made, let us assume that in the United States General Motors sells nothing but Cadillacs, which is the product on which its margin of both gross and net profit is the greatest; let us assume, further, that in Europe it sells nothing but the Chevette, by its European name, which has a significant lower margin of profit. The California formula, by throwing the sales income, et cetera of both products into hotch-pot assumes conclusively that they are equally profitable in terms of the relationship of net profits to sales, property, and payroll. The assumption is economic nonsense. For further illustration, continuing to use General Motors as an example because of its prominence, most of the automobile lines made by General Motors for sale in the United States are not sold in significant volume in Europe, and most of the significant European sales (the European equivalent of Chevette being included) are not offered for sale in the United States at all because here they conflict with American-made automobiles. It is obvious that General Motors does not make the distinction described in order to affect its California taxes; it does so for hard-headed economic reasons. Its margin of profit on its American-made automobiles is certainly different than it is on its European-made automobiles, and they are both designed and built for wholly different markets, to operate on different highway and road conditions.

Another illustration of the point is found in the facts of the recently rendered decision of the board of equalization in the franchise tax appeal of Scholl, Inc., where a Chicago-based multinational parent owning more than 80 percent of the stock of English and other European subsidiaries was held entitled to resist the worldwide application of the unitary formula because the merchandise manufactured and sold in Europe was different and the thrust of the marketing operations in Europe was also different from the markets and focus in the United States.

3. The facts of the situation the California formula assumes rarely exist. This assumption of fact is that the goods sold abroad are manufactured in the United States and merely sold to sales subsidiaries which sell the product abroad. As an alternative the assumption is modified to assume that the goods sold abroad are assembled abroad from components, either entire or major, supplied from the United States factories. With pharmaceuticals, there is a certain validity to the first assumption but it is not universal in any chemical company, and is borne of a state of business affairs which has not been economically viable for many, many years. The second assumption, concerning the components being manufactured in the United States and distributed to factories abroad where they become parts of products employing those components and assembled elsewhere, assumes a set of facts which undoubtedly does exist to some extent or another. It is also true that some industrial empires may manufacture components in one foreign country and send them to another where, in conjunction with components domestically manufactured there they are assembled into a final product.

Neither situation justifies the assumption that the margin of net profit in terms of property, payroll and sales is the same for the products manufactured abroad as it is for the products manufactured in the United States, whether the goods manufactured abroad be made of entirely U.S. produced components or otherwise. The difference between labor costs and productivity abroad, and the margin of profit at which goods are sold abroad, prevents any assumption being made that the final article sold abroad is equally profitable and only equally so, compared with that manufactured and sold in the domestic economy.

The rules applied under section 482, IRS, for dealing with that type of situation are particularly well understood and well developed, because they were developed precisely for that type of situation. They are aggressively administered by the Internal Revenue Service. The States do not need to administer them but can ride the shoulders of the Internal Revenue Service and take advantage of the final determination they make. The necessity for the distorting formula is not genuine, but is argued for because, first, it leaves the administration entirely within the hands of the particular State, and two, its operation generally allocates more income to the taxing State and hence takes a bigger bite from the profits of the nonresident, nonvoting, foreign corporation.

4. The formulary system cannot function without converting foreign exchange into United States dollars. During the many years in which the Bretton Woods convention was in effect and United States and foreign currencies had a fixed exchange relationship with each other, this did not represent a serious problem. However, in the first years after World War II when currencies were fluctuating madly and the U.S. currency was at a premium, the problem was understood and considered to be insurmountable. A rule that was applied to make formulas workable where they were applied was a generous treatment of the principal of "blocked currency," in which funds which could not be exported without a license were not regarded as being exchangeable into United States dollars until the license was obtained. In effect, this made the use of formulae impossible on a universal basis. Within the last several years, in which currencies have been floating, the formerly orderly relationship has been replaced by chaos. The accounting profession and the SEC have devised a system in which foreign currency translations must be taken into account currently even though the actual exchange has not been made. This has lead to wide fluctuations in the earnings of U.S. based parents and has lead to wide swings in the values of stocks of such corporations on the local exchanges. However, the franchise tax board, in apparent recognition of the inroads this would make on the State revenues, has refused to apply this system for dealing with these exchanges. Obviously, the system deals with a condition which must be reckoned with, and whatever may be said for one system of dealing with it compared to another, the problem is difficult and will not go away.

To illustrate, let us assume that X company through subsidiaries does business in 34 different countries in the world, and let us assume further that the relationship between the local currencies of each of those countries at the beginning of a particular taxable year differs from the rate in effect at the end of the year. This is a likely assumption. Sales revenues come in throughout the year, and not on January 1, and December 31 exclusively. As received, they are deposited in banks, ordinarily in terms of local currency, and the occasion for determining their exchange value does not arise until they are sought to be repatriated or sent to a bank in some other country. This, however, can arise at any time. The occasion for doing so will not likely be delayed until the end of a particular calendar year or the beginning of the next one. There will, accordingly, probably be continual withdrawals and translations into foreign exchange throughout the year, with intermediate transactions in which the funds may go through accounts in one or more intervening countries before any occasion for their being translated into U.S. dollars occurs. Indeed, to the extent that they are used in operations, which will be normal and continuing, exchange translation losses and gains will be continued and will continue on, and will be netted at the end of the year. To the extent they are expended in purchasing assets, instead of services, their tax effect is not immediate and must be postponed because they become a part of inventories or they become a part of machinery or equipment, and the translation into U.S. exchange may be deferred for a considerable period.

Then ultimately the funds will need to be translated into United States exchange in order to be reflected in tax returns for the franchise tax board, the

Internal Revenue Service, or some other U.S. taxing agency. The result of the translation is likely to be arbitrary, because the translation of foreign exchange into U.S. currency will be arbitrary unless the receipt of funds by the multinational group is contemporaneous to the day with its translation into U.S. exchange. Any deferment while the exchange rates are fluctuating will necessarily produce a rate of exchange inconsistent with the theory that the parent has had an immediate realization of any gross income received by its subsidiary, in whatever exchange.

The foregoing is not merely a conceptual difficulty. If it were, the necessity for the large exchange translation losses which now are appearing in the annual reports of American-based multinationals as a matter of course would not occur. The magnitude of those exchange losses indicates that they are not something that should be lightly discounted.

Furthermore, the problem is presented of how to take into consideration investments of a permanent nature, made from foreign funds, but where the investment must be translated into U.S. dollars in order to express depreciation in U.S. dollars, and to enter into the property factor in U.S. dollars. As a rule, as a matter of sheer necessity, the rule of thumb is employed that the exchange rate at the time of the investment continues to be employed for both purposes of depreciation and property factors. Yet this is theoretically wrong in each instance. But it is done because in an imperfect world we must sometimes make concessions to practicality. Yet the effect, when the U.S. dollar is declining in its dollar relationship to foreign exchange, as is now the case, is always to overstate values apportionable to the United States and thence to California.

The only way of making a precise calculation is to adopt accounting and bookkeeping requirements so onerous and expensive that to do so is economically counterproductive. The franchise tax board does not render any assistance in this respect, but expects the taxpayer to do this work for it. Yet the necessity to do so is of the franchise tax board's creation. Consider, for example, the question of why a foreign division headquartered in London would need to have a daily translation of currency from bank deposits made in Singapore, Calcutta, Madras, Colombo, Karachi, Johannesburg, and Cairo, into terms of British pounds, and then from British pounds into U.S. dollars. There is no commercial necessity for that effort, but to determine precisely those things the Franchise Tax Board of California needs to know, and other States employing the same system, that translation should be made. Yet these intermediate funds never come to the United States and the only occasion for translation which exists is to convert them all into British pounds, though not daily. This type of recordkeeping involves onerous burdens and expenses, and, of all things, is being hoisted upon these worldwide organizations in order to satisfy the requirements of a political subdivision of one nation, which itself is not an internationally recognized sovereign and is but one of fifty States. Each of the fifty could have different requirements. Each country in which the organization does business can have different requirements, all different from the requirements found anywhere else. Sovereign countries have the right to insist upon such monstrosities being performed as the price of doing business within their borders, but it seems entirely wrong that the United States should not only have its own requirements as a condition of such permission being granted, but should be in the position of permitting its fifty subdivisions to do the same.

5. The apportionment formulas are also theoretically unsound, and practically distortive, because they are indifferent to peculiar local impact of customs, laws, and regulations. For example, there are countries in which women with children are not permitted to work outside their own homes, with the result that there are cottage industry conditions, in which the labor force is largely categorized as independent contractors. Their compensation does not enter into the payroll factor. They are often quite capable of supplying their own sewing machines, for example, and do not use any equipment of the company for whom they work, so the sewing machines do not enter into the property factor. Hence the equipment they use, though it may be paid for by the employing corporation, and the compensation they receive, though it is geared to that received by salaried or wage-earning employees, will both be excluded from the factors (property and payroll) designed to prevent foreign income from being apportioned into California. The only role their operation will play in the factors is that the goods they produce will be shown as foreign sales. But even this will not be so if the sales of their products are sold within the group and ultimately end up as sales

to customers in the United States, because inter-company sales are ignored. It is not uncommon, accordingly, for millions of dollars of income from the foregoing type of transactions being unrepresented in the foreign aspects of the allocation formula. The distorting effect, if the purpose of the formula is to attribute to California only the income derived from operations within it, is obvious. No attempt to defend it as a reasonable apportionment to California of the income it creates can possibly be made. But to object to it is to end up in court. Undoubtedly such cases are in court, but they have not reached final decision.

Another illustration is the local laws not uncommon abroad which in effect prevent an employer from discharging an employee. The result is that compensation may continue to be paid to such empolyees for what is essentially retirement purposes. Retirement pay does not enter into the payroll factor in the United States, but it can be made indistinguishable from compensation for current services rendered in such foreign countries, because the law requires that the employee be permitted to show up for work. If the only distortion that situation produced were in the payroll factor, it would serve to reduce the allocation to California because the out-of-State payroll would be inflated by something not found in the weighing of California payroll, but the economies of such countries have a way of adjusting themselves to such constant conditions, so that prices are higher and hourly rates are lower. The higher price received for the merchandise abroad may not be compensated for by a corresponding increase in the net profits. It is difficult to be certain that this type of condition operates adversely to the taxpayer who must report to California, but it clearly is a disruptive and distorting condition, which requires endless accounting and development of the facts at great expense, to root out.

More serious are varying foreign requirements concerning the determination of currently deductible expenses and depreciation. For example, some countries permit immediate deduction of the cost of machinery and equipment and provide no depreciation deduction for such property. Where that is so, the foreign income is reduced more than it should be in the year in which the machinery is purchased, but in later years the income is larger than it should be by California standards because there is no depreciation deduction, and furthermore there is no property investment shown in the property factor to draw income outside California.

The California or U.S. property, on the contrary, has been capitalized and continues to appear in the property factor. Hence the property factor becomes larger in terms of U.S. and California values than it should be and this inevitably draws more income into the taxing maw of California.

Theoretically it is possible to make the necessary adjustments so that California income will be calculated on California's concepts. Unfortunately, the cost of doing this is impossible to sustain, because it means that auditors trained in the California system must travel the world and reaudit every local operation of a worldwide organization to put them on a California footing. If California had the same majestic authority as the United States this might conceivably be at least theoretically supportable, but when it is recalled that California is but one of fifty States the obligation to do all of this to satisfy it seems to be more of an impertinence than a genuine obligation.

6. One of the significant and certainly the greatest distorting factor is that California allows no credit or deduction for foreign income taxes paid to the foreign countries in which the businesses operate. It is idle to pretend that the burden of income taxation is the same in the United States as it is in every other country in the world, and therefore the assumption cannot be made that there is substantial uniformity in the extent to which income is reduced by the tax burden. In some countries the income tax rate goes as high as 85 percent. In other countries there are tax holidays and there are no income taxes. California treats the income from both countries the same; it ignores the presence or absence of foreign income taxes.

It is obvious that a U.S.-based parent with foreign subsidiaries cannot hope to realize more from its foreign subsidiaries than the dividends it can get from the subsidiaries' net income. Since the foreign governments have the right to impose taxes on the net incomes of the foreign subsidiaries the parents cannot hope to realize dividends which ignore the tax burdens. California should not be in a better position to enjoy those net profits than the parent corporations, but it claims to be; it claims that they should report to California the net income before taxes and pay to California what is essentially an income tax on an income tax. By this is meant that perhaps 50 percent of the foreign pretax net income goes to the foreign government in taxes, but California insists that the entire 100 percent of pretax net income by taken into account in reporting to it, and its approximately 10 percent franchise tax is asserted on the pretax net income, thus increasing the effective rate by doubling it, and imposing a California income tax on amounts that actually are paid to the foreign countries in income tax to them.

Since each foreign country can, as has been said, establish its own rate of tax, and its own methods by which several taxes may be asserted at city, State and local levels, the effective rate of taxation from country to country can vary widely, and completely destroy any assumption that business done in one country is as profitable after taxes as in another country. California's assumption is, however, that all are alike.

B. There are a number of objections to the use of the so-called unitary consolidated formula which are peculiar to corporate groups headed by a foreign-based parent (foreign multinational).

1. Foreign law controls the parent corporation and its non-U.S. affiliate, and California law must necessarily be subordinate to the demands of foreign law of the country of domicile. In addition, it is subordinate to the foreign law of the countries where subsidiaries operate. This can affect the availability of information of the type California's statute and regulations call for if the consolidated unitary formula is to be used.

a. Accounting requirements and standards for the entire group will ordinarily be determined by those of the country of the domicile of the parent corporation. However, the group must also follow the accounting requirements and standards of the country in which their subsidiaries operate. These can differ from California practices in the following respects: first, local law may permit deductions for purchased assets which differ in two different types of respects from California's procedure, one of which is the rate of depreciation, because foreign countries are usually more liberal with depreciation standards than is customary in the United States, and also the frequent allowance of a current deduction for a new plant or equipment in it instead of requiring that the expenditure be capitalized and recovered only through depreciation. Either requirement will have two distorting effects on the formula: first, the foreign property will be shown at a smaller figure than comparable California property, either because it has been entirely deducted at the time of purchase or because the rate of depreciation causes it to disappear from the balance sheet more rapidly: if the foreign parent makes a strong effort to comply with California's requirements it will seek to make adjustments in its net income and in the balance sheet accordingly, but this probably is a rare and exceptional adjustment.

A second type of differing requirement is the use of cash basis instead of accrual accounting, and in different concepts of how inventory accounting is to apply. It is quite unlikely that every country in which the group operates will employ methods like those employed in the United States for tax purposes, and if the parent uses its power to enforce uniformity it will be to satisfy the law of State of domicile and not the law of California. The result will be that the net income and the property and the sales will not be shown in foreign operations on the basis which is consistent with that which is shown in California operations. Finally, the rules of foreign countries on the taxability of nonrepatriated funds will influence the net income shown by the parent corporation for tax purposes and in its reports to its shareholders, and they will almost certainly differ from those California employs, because California does not recognize that funds not yet repatriated can be excluded from reported income.

b. The foreign parent corporation is often prohibited by the law of domicile from reporting to California some of the information California needs for the application of its formula. If it is engaged in defense work it will likely be prevented by law from making any information at all available to a subdivision of a foreign power concerning its defense contracts, products made thereunder, and costs, plants, and payroll. Yet California may regard that portion of its business as unitary with the portion done in California, and insist upon compliance with California law requiring reporting of that information. There is headlong conflict between the two laws and obviously the law of domicile must control the conduct of the foreign parent.

Either California must waive its requirements or guess, and then the foreign corporation is prohibited by the law of domicile from coming to court and disproving California's guesses. Not only is the result unfair, but it is something which United States law, being also a law of domicile, should appreciate as improper and should prohibit.

c. Frequently the payroll figures and the figures for rental of real property, paid by the subsidiaries operating in other countries than the State of domicile, will not be known to the parent corporation. In many countries of the world such figures are not reported to local governments, and therefore are not segregated in reports made or in records retained. The requirement to disclose the information may be 5 or 6 years after that year has terminated, and figures will no longer be available.

2. California's statute not allowing the deduction of foreign taxes based on or measured by net income produces hardship which has been discussed in the earlier division of this memorandum, to which it is equally relevant. There is, however, an additional hardship imposed when the parent is based in another country. It will be required to reconstruct for California's benefit the taxable incomes of its subsidiaries, which may be known to the parent only to the extent that there is something left over after paying foreign taxes. A U.S. parent whose stock is listed on an exchange will require that information be made available to it in order for it to properly report to its shareholders, as a requirement of the United States law, but the foreign parents have no such legal requirement enforced by the law of domicile, and hence may not require that information of the subsidiaries. They are unlikely to require it merely because California wants it. Moreover, they should not be required to provide it merely because California wants it.

Moreover, there is a wide variation in foreign taxes. The value added tax is allowed as a deduction by California law, and franchise or other taxes measured by net worth or assets invested are allowed as deductions. Some countries, or their political subdivisions, have triangular taxes, in which the tax actually paid is measured by net income only if that tax is greater than the tax that is imposed if measured by gross payroll or by property invested. In those years in which one of the two alternative measures produces a higher tax than the net income measure, the tax is not measured by or is not on that income and therefore it is deductible, but in the year in which it happens to be measured by net income it is not deductible. This is a quixotic result, which obviously can cause a pendulum movement of the foreign income which is not related to the income produced in California in the slightest. It is difficult to think of the slightest excuse except arbitrary statutory provision for such distinctions when they are the result of foreign laws, obviously not adopted in order to increase or decrease California's taxes.

3. The domestic subsidiary is the one which must deal with California. California imposes the tax on it even though it is measured by an apportioned amount of the foreign group's net income. The domestic subsidiary cannot force the foreign parent to revise its accounting system or release prohibited information in order to conform to California law. The foreign parent should not be forced to make a choice between revealing information prohibited by local law and sacrificing its California subsidiary to California taxes exceeding the correct amount. It is not good public policy for the United States to tolerate such conduct from one of its political subdivisions.

4. The entire area of California or other State taxation of domestic subsidiaries of foreign based parent corporations is permeated with foreign policy considerations. California is not supposed to make its own foreign policy; indeed, it is not supposed to have an independent foreign policy. It is prohibited by the United States Constitution from entering into treaties with foreign countries. Its policies must necessarily yield to the foreign policy of the United States. If it is the foreign policy of the United States to permit foreign-based parents to form subsidiaries to operate in the United States, in consideration of the foreign countries permitting subsidiaries of U.S. based parents doing the same thing, then it is, or should be, U.S. foreign policy not to permit taxation of the income of those foreign parents by States in circumstances in which the United States itself does not do so. If there is no permanent establishment maintained by the foreign parent in the United States it is not subject to the demands of the United States, and the States should be similarly bound.

The States contend that they must be left free to use their unitary concepts with foreign groups because the foreign groups will cheat in reporting taxable income in California and this cheating will not be disclosed by the fair price method and Internal Revenue Service administers under section 482. If California is right that the foreign groups will cheat, then it has not found the remedy for this in its unitary system. A foreign corporation that plans to cheat California can do it just as effectively under the unitary method as any other. California is helpless, where the headquarters of the multinational corporation is in a foreign country, to verify the figures the foreign parent may choose to submit to California.

It has no power to make an audit in the foreign country, and it must be assumed that if a foreign parent plans to cheat it will be intelligent enough to close the doors to the franchise tax auditors in order that it might cheat without getting caught. It's true, of course, that California can have the same access to published reports to shareholders of foreign parent corporations that it has with respect to U.S. based parents, but it can do so only when such reports exist. Many influential and successful foreign corporations do not publish annual reports because they are privately held and are not listed on exchanges. In some countries the type of report California is accustomed to thinking of is not required by law even if the foreign parent's stock is dealt with on exchanges. It is a safe assumption that many large foreign parents can give California any tax or figures it chooses to without any likelihood that California will be able to make an effective audit to verify or correct the figures submitted.

The domestic figures will be known, presumably, but the property, payroll, and sales in foreign countries will not be known, frequently, and even the net income will not be known. If the foreign corporation wishes to report them to California and wishes to report them to California as figures designed to produce the smallest tax possible, California will either not know or will not be able to verify its suspicions.

By contrast, California's having the availability of Federal enforcement and administration of the fair price method is a much more secure assurance for California. Because the wide and varied type of foreign figures are not relevant to administering the fair price method, the administration of the system is concerned with fewer facts and figures which are suspect and which might be fabricated. Furthermore, it is more likely that a foreign corporation will be more impressed by the might of the United States than the might of California, in determining whether or not to respond to demands for information to permit the taxes to be verified.

It can be seen, accordingly, that the complaint of California that it will be given fictitious figures if it is not permitted to use the unitary system will not withstand analysis. It has less likelihood of being able to make the verifications it needs of the information required for a proper administration of the consolidated unitary system that it needs to administer the fair price method, particularly in the light of the assistance it can get from the Internal Revenue Service in the administration of the latter system.

C. The following is a checklist of the differences between foreign countries and business conducted in them which the consolidated unitary formula ignores.

1. *Differences in languages.* This makes international institutionalized advertising both difficult and ineffective, and even makes trademarks and tradenames of limited international value. As an example, the well-known United States name, Scholl, is pronounced School in the United States and Skoll in Great Britain. Moreover, language differences make transferability of personnel of limited use in a multinational corporation, and makes uniform training manuals useless unless they have been translated into different languages. However, they also run up against differences in customs, both religious and social.

2. The differences in custom are apparent in the business of making phonograph records. A multinational phonograph record company will find itself making different records with different performing artists and different tunes in Turkey than in Denmark, and in Greece than in West Germany. There will not be the universality of product which the unitary system assumes exists. Nor will there be the savings obtainable from economies in scale when an international product can be made to a single standard and universally merchandised.

The same is true of cosmetics, although perhaps not to the same degree. Some skins are dark-complexioned and others light; some skins are oily and others dry; some hair is characteristically brunette and other is predominantly blond. An international manufacturer and purveyor of cosmetics will therefore find itself making different products to purvey in different countries, and will be advertising accordingly. There is not the international universality that cosmetic advertising in the United States suggests is the case here.

Advertising media differ in different countries. A successful jingle in the United Kingdom may, on being translated into a foreign tongue, be offensive to the people of several countries. Television may be a highly successful medium in the United States and in Great Britain, but is of limited use in mountainous countries and countries with characteristically low incomes. Newspaper advertising is of value in countries with a high degree of literacy and useless in countries of high illiteracy. Some countries discourage billboard advertising along roads and highways and others make no effort to regulate it or prevent it, and the variety of conditions will produce entirely different forms and customs in the differing countries.

These considerations mean, accordingly, that the task of appealing to the public is not one which can be successfully dealt with from the offices of an advertising agency on Madison Avenue or a corresponding location in London, or Dusseldorf. The idea that international corporations sell their products by international means and therefore the expenses should be the same everywhere is simply not factual.

Moreover, different conditions require different products, as illustrated above with the phonograph records and cosmetics. In Europe farms are small compared to those in the United States, and in some countries are very much more hilly. This means that tractors will be different than they are in the United States, and so will harvesting equipment and even the rig which takes the product to market. A truck that would be used as a matter of course in the United States may turn out to be a horse-drawn cart for the small farmer near Innsbruck. Yet, the large U.S. manufacturer of farming appliances and trucks will be represented in Austria by products suitable for sale there, and to the California Franchise Tax Board those operations will be unitary with those conducted on the wide plains of the Midwest or California.

3. Tax administrators of an American State have difficulty realizing that foreign countries have customs duties to bar importation of goods from other foreign countries, if that importation interferes with the domestic economy. The existence of customs and duties puts an artificial limit on easy transferability of products between countries, and is a factor which must be taken into account in the design and manufacture of every product designed to be sold in several countries. In some instances this will mean greater domestic content. In other instances it will mean a reduction in horsepower or in weight, to avoid getting into a higher tariff level. In others a most favored nation clause will make the manufacture of a product in a less economic environment desirable in order to enjoy a lower rate of tariff when the product is exported into a particular country.

These and similar consequences of the existence of customs barriers means that the free flow of merchandise across political lines which exists in the United States does not exist outside the United States, and the heart of the unitary assumption, which is that the business will operate at substantially the same profit levels and with substantially the same interflow of product that is customary in the United States, is false in international business.

4. Each country has its own legal requirements concerning fringe benefits and social security taxes, because, as in the United States, these become subject to political influence and pressure. Foreign business ordinarily does not put those benefits and taxes into its payroll figures, and yet compensation treated as payroll will vary greatly accordingly to the amount of fringe benefits, employment security and retirement security that the employer provides either willingly or, by local custom, or taxation. Essentially the result is that the payroll figures need to be edited in order to be put on a uniform basis of measuring worker output.

5. Also, pay scales from country to country vary widely. Pay scales in Singapore encountered by the semiconductor industry approximate 10 percent of those rates prevailing in the United States and the Singapore worker is also skillful and reliable. There is not a great variation in performance, but a tremendous variation exists in pay scale. To measure both in terms of dollars without some adjustment is patently wrong, but California characteristically refuses to make that adjustment.

Moreover, even where pay scales are not greatly disproportionate in appearance they may be in fact because of great variations in the hours worked for the same pay, and in working conditions. In many foreign countries the coffee break is unknown, but it is known in the U.S. In many foreign countries 44 hours and even 50 hours a week will be the basic work week so that the apparently similar pay scale will be for more work in the foreign country than in the United States. These examples can be extended almost indefinitely.

6. There are differences in mark-up in sales to different countries, and in the sales of goods manufactured in different countries caused by customs accommodations, import agreements, and the hazard of doing business in the destination country. These mark-ups should and ordinarily do produce higher profits, but the equalizing effect of the formula disregards the source of the profits and instead reapportions them out according to sales, payroll and property. It is obvious that if the mark-up is 20 percent instead of 10 percent fewer sales at the 20 percent mark-up will produce a higher profit than larger sales at a 10 percent mark-up. This is an illustration of what the California formula conveniently ignores.

CONCLUSION

There is universal condemnation of the type of consolidated unitary apportionment of net income California employs, in the ranks of those who do business between the U.S. and foreign countries. There is no more admiration for the system in the case of U.S.-based multinationals than in the case of foreign-based multinationals. The basic conditions producing distortion in the use of the formula are the same, whether the parent be based in the U.S. or abroad. The differences that exist between U.S.-based parents and foreign-based parents are that the information California requires is more likely to be available for the U.S.-based parent to supply than for the foreign-based parent to supply.

However, the foreign-based parent is in a better position to take self-help, if it is the kind of taxpayer the franchise tax board's arguments in defense of its system imply. The franchise tax board's contention is that multinational corporations cannot be trusted to provide proper and correct figures to it, and therefore it cannot have the facts it needs to make an accurate determination of how much net income the business actually derives from California. However, everything which it says is equally true, particularly with a foreign-based parent, of the employment of its formula. If the assumption is made that the foreign-based parent is going to supply California with false or fictitious figures in order to avoid its taxes, it has at least an equal opportunity of doing that under California's consolidated unitary system.

It is suspected that the real reason California has such a zeal for this system is not the reason mentioned above, but that is produces more taxes because it allocates more income to California than any other method. In analysing this possibility, the fact should be borne in mind that the foreign-based taxpayers do not have representatives in the California Legislature, and neither do the corporations headquartered in other States than California. Imposing taxes on foreign interests that have no realistic recourse to the California Legislature in which to complain can readily be regarded as a safe and popular way of raising revenue. However, the old concept behind lodging supremacy in the Congress to regulate interstate and foreign commerce was because of those local tendencies and fear that they might interfere with commerce unduly. This is what is happening through the consolidated unitary taxing system, and that system should be regulated by the Congress to the end that income earned outside California should not be taxed by California, and its taxes should be measured only by the income the business group has succeeded in earning out of its California business.

Prepared Statement of Mark G. Ancel

Mr. Chairman and members of the committee, I appreciate the opportunity which has been given to me to testify with respect to the problems inherent in the unitary method of apportioning income derived from the activities of corporations conducting business, both within the State of California, while at the same time conducting business within other States and within other countries of the world. I intend to direct my remarks to the area of the administration of such tax, from the viewpoint of the State and of the corporate entities involved.

Before proceeding into this area, however, I would like to set forth my background. I am a lawyer and a member of the firm of Baker, Ancel, Redmond & Hall. The firm maintains general practice in Los Angeles, California. I have been a member of the American Bar Association and of its section of taxation for approximately 15 years and have participated within that section as a member of the committee on state and local taxes. As a member of that committee I have been its assistant chairman, chairman and special advisor over a period of 8 years and, among other matters, have concerned myself with problems involved in taxation of businesses engaged in interstate and foreign commerce and with the proposed convention between the Government of the United States and the United Kingdom in respect to paragraph 4 of article 9, since reserved by the United States Senate.

I have also participated as chairman of a panel for continuing education of the bar proceedings involving California corporate and personal income taxes and sales taxes. I am currently chairman of the State and Local Tax Committee of the Los Angeles County Bar Association, Section of Taxation. A substantial portion of my practice is in the area of State and local taxation. While my firm represents a number of clients who may be affected in one manner or another by any legislation which may be forthcoming, as a result of the committee's investigation, my appearance is solely my own action undertaken in the hope that I may be of some aid to the committee in identifying some of the problems which I believe to be inherent in the California unitary approach to business conducted on a worldwide basis. I am not speaking on behalf of any particular client nor on behalf of any particular business group or bar association. I now have, and have had from time to time, various matters before the California Franchise Tax Board which do involve the problems of worldwide combination and apportionment under the California unitary approach. However, I speak in my private capacity as a citizen of California on the basis of what I believe to be some knowledge and experience in the area.

I consider it my duty to and I do support those efforts which are made to protect the public revenues of State and local government by adoption of appropriate taxing statutes.

However, it is my belief that in the area of worldwide combination and apportionment utilizing the unitary approach, California, for the reasons for which I intend to set forth in greater detail, through the action of its administrators has intruded into areas which are those of the Federal Government and which should be defined by the Congress. I also believe, in light of my experience as a lawyer, and in light of the desire that the President has enunciated to encourage activities having to do with export of goods, that the California approach, in the long run, will be detrimental to its revenues, to the creation of jobs for its citizens and will breed retaliation which may affect the exportation of goods.

First, as a practical matter, the determination of measure of income, places a great burden upon the auditor. How is he going to verify the situation with respect to corporate parent and subsidiaries of corporate groups conducting business on a worldwide basis? The auditor has to make a determination, in the first instance, as to whether or not there exists a unitary group. In this area, depending upon the particular auditor involved and based upon the form of questionnaire which is often times presented to the domestic subsidiary here in California, a determination involving literally hundreds of thousands of dollars is made depending upon how the questionnaire which is filled in by the domestic subsidiary is viewed by the auditor and his supervisor.

Having made this determination the auditor is then going to be required, based upon the various financial reports of the parent, and based upon the books and records of the subsidiary, to reconstruct the net income of the unitary group, not in accordance with what the foreign parent may have followed by way of accounting standards imposed upon it by the law of its domicile, but in accordance with accounting adjustments made to conform profit and loss statements to those utilized in the United States and to those accounting methods reflecting the provisions of California statutes and the regulations thereunder.

In this regard, the income of the unitary business shall be determined on the basis of profit and loss statements prepared from the books of account regularly maintained by each corporation for the purposes of accounting to its shareholders. Consider, for instance, the possibility of obtaining the books and records of a corporation with a home office in Australia or Japan and with subsidiaries who not only do business in California but also in other States of the United States and in other countries. Or, consider the obtaining of the books and records of a closely held foreign parent. The mere gathering of this information can be

States from adopting the unitary method and apportioning the income of foreign corporations. Thank you.

STATEMENT OF VALENTINE BROOKES, CHASE BRASS CO.

Mr. **Brookes.** My name is Valentine Brookes, and by way of my qualifications I, too, was once the attorney representing a State taxation scene in court. I was Deputy Attorney General of California representing the Franchise Tax Board from which you have heard today, and in that capacity I presented the arguments for the State in the U.S. Supreme Court in the famous *Butler* case and I was successful in the outcome. This was the foundation case for the unitary formula allocation. It did not involve foreign business, but a homogeneous American enterprise operating exclusively in this country.

Then later, having developed some antipathy to the idea that the formula could be applied properly to foreign and domestic business, I represented the Chase Brass Co., a subsidiary to Kennecott in the case referred to by Mr. Latcham in which this aspect of that case was decided in favor of the taxpayer. California follows the *Butler Brothers* case which it won, it will not follow the *Chase Brass* case which it lost.

There are inherent flaws in attempting to apply the allocation formula or concept to a worldwide enterprise, whether it be locally owned or foreign owned. The most critical differences between business done in the United States and business done in foreign countries are ignored in an allocation formula because the assumption it makes inflexibly is that a business will be equally profitable in all parts of the world where it does business when that profitability is translated into a geographic location by the use of a formula of property, payroll and sales. The assumption necessarily is that net profit comes equally from every dollar wherever earned of sales, every dollar spent on wages, every dollar invested in property.

Senator **Mathias.** I don't want to interrupt you, but I was wondering how you're going to handle Aeroflot?

Mr. **Brookes.** I think that would be interesting to find out.

Senator **Mathias.** Now that we are looking forward to a new period of rosy dawn in the east, how are we going to handle some agencies or the Chinese government?

Mr. **Brookes.** Well, the answer to Aeroflot is quite easy if it's given rom th inflexible answer the Franchise Tax Board should insist on, s to insist that Aeroflot is owned by the Soviet government, it disregards its corporate entity, so the property tax outside of the United States consists of the Soviet Union.

Senator **Mathias.** So we have to figure in the value of the Kremlin.

Mr. **Brookes.** Yes, we might learn more about the extent of the ussian defense effort that way, we'd be trying to capitalize it and nclude it in out-of-State taxes. S.A.S. is a similar problem, owned by hree foreign governments. And I don't know what the Franchise Tax oard has evolved for them, but if they are consistent with their heories, they should disregard the corporate entity and attribute it all the foreign governments, unless they take refuge in the 50 percent wnership rule and say that doesn't apply here because they only own ne-third each.

Senator **Mathias.** It may retreat to Ralph Waldo Emerson, that nsistency is the hobgoblin of little minds.

Mr. BROOKES. The formula does not only have examples such as the one the Senator has given, but as a simple illustration in Singapore where many American concerns have subsidiaries, and Malaysia where the same is true, the payroll rate is about 10 percent of what it is in the United States for comparable work by comparable skilled people. This is in the semiconductor industry where this is widely involved. The foreign business should, therefore, if the gross receipts are the same, be much more profitable because of the much lower wages paid. So it's a more profitable business than abroad, but in using the formula you use the payroll factor and the payroll factor abroad is weighted one-tenth that of the United States for the same amount of labor. Now, the Franchise Tax Board will not make any concession by way of changing the weighting so that the foreign labor is brought up to equality with domestic labor, so the result is as the business abroad is more profitable its impact grows less in the allocation formula. This is something that happens in minor degree in domestic unitary allocation but in major degree in allocation of domestic and foreign hot spot income.

The theory works best in a quite improbable state of affairs where all the goods are manufactured in the United States that are sold abroad, then are transferred abroad and sold. And if they are sold at the same margin of profit abroad as they are here, the formula works fine. Unfortunately, that set of facts is the exception not the rule. The system will also not work without burdensome record-keeping because much of what California wants to know, and I'm speaking of California because I know it. I don't know Oregon and I didn't know until today how Alaska operated and that the oil companies were different than other companies up there. The record-keeping is so burdensome that if California is a very small end of a tail wagging a very large dog it wouldn't happen. So in essence the records have to be reconstructed after the fact in order to determine payroll abroad, investment abroad, and in some instances sales abroad, particularly of subsidiaries of a foreign parent or subsidiaries of an intermediate parent of an American parent corporation.

The result could possibly be that the certainty that the Franchise Tax Board of California has said that it finds in the formula method as compared to the separate accounting method in section 482 is illusory. We heard this morning that there was a suspicion that these big American multinationals might fabricate some of the figures given to the States and the result would, therefore, be less than ideal. But the opportunity of fabrication in the formula used worldwide is endless.

Take the Deutschmark. A West German company, it has to report to California. Everything is in Deutsch marks. One simple way of reporting is to remove the D.M. and substitute a dollar sign on everything but the net income and send it to California. They have no subpoena power in Germany. I don't know how they're going to find out what the facts are. If then the honesty of the taxpayer is suspect, the opportunity for taxpayers tailoring results to suit their wishes is just as great in the formula as it is in the 482 separate accounting approach.

So the advantage they claim they see in it is illusory, but if it works on the basis of true facts and figures, the result is predictable. It will pull into California income earned abroad not attributable to California. For instance, there is an American company that developed a food substitute, actually a flavor substitute, and after a while it couldn't sell it in the U.S. anymore because Food and Drug said no. They make it now in a factory in Canada, they sell it abroad, they can't sell it here. California wants a bite of that income though none of the income could arise from the United States because the product can be neither manufactured nor sold here.

Another example, phonograph records of the popular sort. In Turkey they very much like popular records of music composed in Turkey sung by Turkish artists. The sale of those records abroad is nil. Also in Denmark the same is true, they have a great taste for local artists and local music, they're not interested in records from the United States in the popular field. So that means there's a different margin of profit, there's a different type of music that must be sought out, a different group of players that must be sought out, a wholly different little business being conducted, but California says it's just like that conducted in California and wants to put them all together regardless of the different margin of profit.

Then, and this is one of the most serious impediments to the reality, California statutes provide that net income taxes may not be deducted from the income used in the formula. Therefore, income of a subsidiary in Sweden where there's a 65 percent rate of tax is taken into account just as fully as income from Puerto Rico which enjoys a tax holiday or from Malaysia which enjoys a tax holiday. The justification that was offered, or one of them, for the formula in this foreign consolidation area is that the States cannot apportion dividends. If they did apportion dividends, the amount would be after tax not pretax. By using the consolidated formula they managed to take pretax income into account. One way of avoiding that, if the corporations have enough impact with the foreign government, is to change the income tax to a value added tax. Tinker with it a little bit and it ceases to be an income tax, then it's taken into account. That doesn't seem to make much difference in economic impact on the company whose income is being apportioned in California.

What I have said applies equally to foreign operations with domestic parents and foreign parents, and there are some differences that make it even more difficult to apply this theory in practice with a foreign parent. The foreign law controls the parent, not U.S. law, not California law. Foreign law may be antagonistic to California law. It may impose secrecy on the foreign parent. If it is a defense contractor in whole or in part, foreign law will impose secrecy on it. It may not give California some of the information it would like to have.

Then there are different accounting standards used in foreign countries than here. In some countries everything is on a cash basis. Here most business done by corporation is accounted for the accrual basis, so there has to be a conversion from one to another. Difficult to do at all, impossible to do accurately, particularly three or four years later.

The standards of inventory adjustment are different in different countries than they are here. And in some countries they permit immediate deduction of the cost of equipment. In California and Federal concepts it's capitalized and depreciated. If it has been expensed 3 or 4 or 5 years later, no one has a record of the cost of it, but for California purposes that must be found. It must be shown in the allocation formula or too much income will be allocated to California. They should get depreciation on it instead of the current deduction. If they don't take depreciation income is too high. And these are more likely to be problems for a foreign-based group than for a domestic-based group because our American multinationals do report, they do keep these records in order to report to the shareholders under the rules the accountants and SEC insist upon. But there's no such requirement for foreign companies unless they have depository receipts in the United States and have had to comply with the SEC.

There are other differences which are ignored, and I'll run through them very, very briefly. International institutionalized advertising is not possible, whereas in this country it is; that is institutionalized national advertising, and this is considered to be a unitary factor. But you cannot advertise in Denmark in the same language in which you advertise in the United States, so you must have local advertising. That's just one random illustration. Peculiarly enough, the words that seem to be pronounced alike throughout the world are not. A client of mine is Scholl that makes foot aids. The name is of German derivation. In the United States it's called School. In the Eastern Hemisphere it's called Skoll. If you go into a store in the United States and ask for Skoll you may be given beer.

The language problem means that there's limited transferability of personnel, limited ability to use training manuals as well as the advertising that I have mentioned. And then, customs duties interfere with the flow of goods from country to country but that doesn't happen in the United States. So there are problems in manufacturing abroad and selling in other countries of local components to avoid or minimize customs. The same is true when we ship abroad or abroad ships here. The free flow of goods in the United States has no counterpart in foreign business but this is disregarded and the assumption is it's just as easy to sell U.S. goods abroad as it is to sell U.S. goods in Florida.

In the wage factor lots of fun can be had with foreign corporations because of all the fringe benefits. If they want to put the fringe benefits in the payroll factor they can boost them up to a point where they are higher than they are in the United States, and I don't know how the Franchise Tax Board is going to be able to audit that successfully.

These are only some of the highlights to illustrate that there is a genuine difference between operating abroad and operating in the United States, which differences do truly make it impossible to have a fair reflection of the geographic source of income when a formula is applied to allocate the income between the states.

I have given an extension of my remarks, Senator, which I am going to ask leave to rewrite.

Senator MATHIAS. Very glad to have your revised edition. Thank you very much.

STATEMENT SUBMITTED TO THE SENATE JUDICIARY COMMITTEE BY THE STATE OF NEW MEXICO ON S.983, THE INTERSTATE TAXATION BILL.

The State of New Mexico opposes S.983 for the reasons explained below.

New Mexico presented testimony and a written statement in opposition to S.2173, the predecessor to S.983. Although many changes were made and some problems were solved, many of the shortcomings of the old bill were carried over to S.983, and there are several entirely new objectionable provisions.

At the outset it might be helpful to briefly describe the gross receipts tax under the New Mexico Gross Receipts and Compensating Tax Act (Section 7-9-1, *et seq.*, NMSA 1978). Unlike a number of other states, our gross receipts tax is not imposed on "retailers"; in fact, our statutes do not have a definition of a retailer or wholesaler. Our gross receipts tax is a tax on the privilege of doing business in New Mexico and the tax is measured by the gross receipts of a taxpayer from the sale of property in New Mexico, from performing services in New Mexico and from leasing property employed in New Mexico. Our gross receipts tax is much broader than the usual sales tax; New Mexico does impose a tax on pure services.

The New Mexico gross receipts tax is imposed on the seller or the lessor. There is no provision in the law requiring or authorizing the "passing-on" of the tax to the purchaser. In fact, in a transaction which is covered by the gross receipts tax, there is no legal liability on the purchaser to reimburse the vendor with the tax, even if the vendor should separately state the tax.

We do recognize that some of the provisions under our gross receipts tax are similar to sales tax provisions. New Mexico, as other states, has typical exemption provisions which provide that certain transactions are not subject to the gross receipts tax. More particularly, our gross receipts tax also provides for certain deductions; these generally provide that certain transactions will not be subject to tax where a purchaser has furnished the seller with a "nontaxable transaction certificate" (NTTC). In such a case, the seller is to report the receipts from the specified transaction and then claim a deduction based on the NTTC received by the seller.

Although the New Mexico gross receipts tax is a Title II tax, not a Title I tax under S.983, we believe it is appropriate to comment on Title I taxes because of the remote possibility that, under Title IV, the Court of Claims could rule that our tax is a sales tax under Title I.

Title 1:

As previously stated we oppose S.983. We have comments on several provisions of the bill which are particularly troublesome.

Section 101. Uniform Jurisdictional Standard. Title I limits the jurisdiction of the state, to tax sales of tangible personal property. This means that, if New Mexico is deemed to be covered by Title I, New Mexico jurisdictional standards would vary according to the type of transaction: the statutory limit imposed by S.983 would apply to sales or leases of tangible personal property, but the constitutional standards would still control, where the gross receipts were from sale or lease of intangible property or services. Thus, the goal of uniform jurisdictional standards is not served by Title I.

The reference to the "power to require a seller to collect a sales or use tax" clearly shows that this bill is designed to cover transactions when a state imposes a pure sales tax--where the legal incidence as opposed to the economic impact of the tax is on the purchaser. This situation does not prevail in New Mexico; our gross receipts tax is imposed on the vendor, not on the purchaser. It is true that under our compensating tax provisions we do require a seller to collect the compensating tax from the purchaser, but this is not true in the gross receipts tax area. Accordingly, it is clear to us that Article I does not apply to our gross receipts tax because our law does not require the seller to collect the gross receipts tax from the purchaser. In this connection, we also have observations on the definition of "sales tax" as contained in §151 of the bill.

Section 151. Sales Tax. The phrase "or is customarily stated separately from the sales price" should be stricken from this section. It is strange indeed that the tax consequences should hinge on the practices of a seller. After all, state legislators have the responsibility of determining tax effects, not sellers of property or services. This objectionable phrase, what ever it may mean, seems to say that taxpayers, who may establish business practices, may also determine whether they are within or without this definition. Moreover, it is not clear to us how one establishes what is "customarily" done. Is this to be done by geographical area, by industries or do you look solely at the custom and practice of a particular taxpayer?

Title II:

Section 201: Uniform Jurisdictional Standard. If New Mexico's gross receipts tax is covered by Title II, as we think it is, the same jurisdictional inconsistencies discussed above, at Section 101, exist here.

Section 251. Gross Receipts Tax. As previously indicated we think that the New Mexico gross receipts tax falls into this category for purposes of S.983.

Section 252. In our view, the use of the words "business office" rather than "business location" as used in §157, is improper. We believe the uniform jurisdictional standard for the gross receipts tax in §201 should use the "business location" test rather than a "business office" test, as defined in §252. Thus, §252 could be eliminated and §253 could be expanded to provide that business location has the same meaning in Title II as in Title I.

Income Tax:

The income tax provisions of S.983 dramatically invade provinces always heretofore reserved for the states; many of these provisions also appear in S.1688, which is currently before you for consideration. Although the courts have recognized in many instances that a state has valid reasons for considering the amount of foreign source or dividend income received by a corporation, in calculating the income tax due to the state, S.983 prohibits the states from considering those amounts. The bill also prohibits voluntary or mandatory reporting on a worldwide combination basis.

The states have made great strides in approaching uniformity and equity in the taxing of multistate and multinational corporations. In the absence of encroachment on federal constitutional guarantees, state income taxation is an area of law traditionally reserved for state policymakers. States are best aware of state's needs and problems and best able to determine fair taxing methods to meet those needs. The United States Constitution adequately protects taxpayers from possible inequities.

The provisions of S.983 regarding income taxes intrude unnecesarily into these areas of state concern. The Multistate Tax Compact and the growing interest among the states in uniformity of taxation will ultimately achieve the goals of S.983, without federal interference.

For these reasons, as well as the reasons expressed in opposition to S.1688, New Mexico opposes S.983.

STATEMENT SUBMITTED TO THE SENATE FINANCE COMMITTEE BY THE STATE OF NEW MEXICO CONCERNING S.1688

The State of New Mexico opposes adoption of S.1688 for the reasons explained below.

There are two major provisions of S.1688: First, despite the trend among the states to treat unitary businesses as one taxable entity for state taxation purposes, and to apply formula apportionment to determine the fair amount of the total corporate income attributable to the taxing state, this bill prohibits a state from recognizing any foreign orporation as part of a unitary domestic business for taxa- ion purposes. Second, the bill substantially limits the tates' power to impose an income tax on any portion of the ividends paid by a foreign subsidiary to its parent doing usiness within the taxing state.

Both of these provisions restrict state taxing authority nd will substantially reduce revenues collected by the states. ncreased federal restrictions on the states in the taxing area re unusual, and in this case unjustified. The states have teadily progressed toward greater uniformity in the taxation f multistate and multinational corporations. The federal imitations on state taxing authority are the requirements of undamental fairness, as required by the Due Process and Equal rotection Clauses of the United States Constitution, and those on-discrimination requirements necessary to maintain open commerce among the states, contained in the Commerce Clause. These limitations are reasonable and necessary, and any abridgement is zealously prohibited by the Courts. However, the provisions of S.1688 advance none of the interests listed above. S.1688 encroaches upon a function unique to the individual states -- determining the methods of taxing of and calculating the extent of corporate activity within its borders. Defining the state's tax base has always been a state function. Congress is unfamiliar with taxing problems unique to the states and should not meddle with state taxing formulas.

New Mexico has dealt with some of the difficult areas as follows. Because of the many problems inherent in identifying a multinational business's income separately attributable to only one state, New Mexico has allowed taxpayer corporations to elect to file New Mexico tax returns on a combined basis with its subsidiaries with whom it conducts a unitary business, through a system of allocation and apportionment. The entire unitary business reports to New Mexico that portion of its income which is attributable to New Mexico sources. This policy recognizes the interdependence of various aspects of a unitary business, and the difficulty of determining by separate accounting the exact contribution of each aspect of the business to the total business. In some cases, apportionment of income of the unitary business is the only reasonable method for determining income earned within the taxing state. This reasoning applies no less to a multinational corporation or multinational affiliated group of corporations than to a corporation doing business only in New Mexico or only within the United States. While New Mexico has never *required* a foreign subsidiary to be included in a unitary business for apportionment purposes, it does *allow* a taxpayer to elect to include the foreign corporation as part of its unitary business. However, where a unitary domestic business receives, as business income, dividend income from foreign subsidiaries not included in its unitary business, New Mexico requires inclusion of the dividends as apportionable business income of the taxpayer.

S.1688 would prohibit inclusion of the foreign corporation as part of the unitary business, and eliminates state taxes on dividends paid by them, thereby allowing a potential benefit to multinational businesses not enjoyed by domestic businesses; that is, the bill provides the clear opportunity for interrelated affiliated corporations having a foreign subsidiary to centralize income in a foreign subsidiary, and receive the profits back as nontaxable dividends from the subsidiary, thereby substantially limiting corporate tax liability to any of the states in which they do business.

As anyone who is familiar with the problems of separate accounting knows, it is very difficult for a large group of interrelated affiliated corporations to accurately account for the activities of any one of its corporations and determine the exact amount of income attributable to that corporation. One corporation may be the money maker, being subsidized by corporations feeding it raw materials or services at a loss. Given proper incentive it is not difficult to manipulate affiliated corporations, to centralize the income in one designated corporation. S.1688 provides the incentive for such manipulation, by allowing a special tax break. The upshot of this income "hiding" is that a domestic corporation or group of corporations may do a lot of business in a state, but realize very little income and therefore incur a very small state tax liability. Ultimately, the domestic income is increased by dividend payments, but since the bill also limits the taxes on dividends paid by those foreign corporations, the apportionable business income of the corporations never reflects the actual amount of business income received by those corporations. Thus, the bill erodes the tax base of each of the states applying the unitary business concept.

Furthermore, S.1688 would discriminate against local and domestic businesses in favor of large multinational businesses. A domestic corporation doing business within the State of New Mexico has a reasonable tax burden on that income earned in New Mexico. However, a domestic corporation affiliated with a foreign corporation may arrange its transactions with that corporation so as to reflect very low income, while its foreign subsidiary recognizes the income. The normal incentive of any business to realize a profit is reduced by its ability to deal with an affiliate subsidiary at less than arms length, so that it can ultimately distribute the same amount of money to corporate shareholders, but avoid imposition of state taxes.

Finally, S.1688 would force the state to return to separate accounting, an ineffective alternative method for examining the real income of a domestic corporation; that is, reexamining all the dealings and financial arrangements between these subsidiaries of a multinational, and trying to reconstruct them to approximate what the profits of each would have been, if an entirely separate company rather than part of a multinational. Because of limited state resources, such an analysis could be undertaken in only a very limited number of cases. In most cases the state would be dependent upon the corporation's characterization of its ncome, and would be unable to review or adjust the figures resented by the multinational, even if those figures were nadequate or inaccurate. The state's ability to audit ccurately is undermined; S.1688 encourages tax avoidance n a multinational level.

For all the above reasons, New Mexico opposes passage f S.1688.

Anderson Clayton
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STATEMENT OF LYLE BETHUNE, ASSISTANT CONTROLLER & DIRECTOR OF TAXES ANDERSON, CLAYTON & CO., HOUSTON, TEXAS TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE

Honorable Chairman and Members of the Subcommittee, we appreciate your allowing us to present our Company's viewpoint concerning certain provisions in S. 1688.

Anderson, Clayton & Co. is a Houston based food company whose major operations are in the United States, Brazil and Mexico. It processes and markets consumer and institutional foods, oilseed products, animal and poultry feeds and planting seed. The Company's non-food activities include Ranger Insurance Companies, American Founders Life Insurance Company, Long Beach Manufacturing and Gulf Atlantic Distribution Services.

In addition to domestic operations, Anderson, Clayton & Co. has major foreign subsidiaries in Mexico and Brazil. Early in the 1930's Mr. W. L. Clayton recognized the potential of Latin America. New subsidiaries were formed primarily for purposes of conducting cotton merchandising and cottonseed crushing operations in Mexico and several South American countries. Companies in countries other than Mexico and Brazil were subsequently liquidated or sold because of the poor business climates created by the governments of those countries. Most of the subsidiaries were 100% owned; however, the laws of both Mexico and Brazil encourage an eventual partial ownership of all corporations by nationals. The Company has voluntarily reduced its ownership in Mexico to 60.8% and in Brazil to 75.7% through sale of stock to the public. The companies are listed on the public stock exchanges in their respective countries.

The operations of the foreign subsidiaries, while substantially similar in nature to those of Anderson, Clayton & Co., are autonomous. Except for soybean products and green coffee, the products handled by them are produced, processed, sold and delivered within the respective countries for the most part, and by their nature are largely non-competitive with U. S. products.

At the present time, Anderson, Clayton & Co. operates domestically in 43 states and files 29 state income tax returns and 27 state franchise tax returns.

We feel that passage of S. 1688 is needed by American business in order to correct certain inequities of interstate taxation.

Combined or consolidated reporting

The Company has consistently taken the position that its operations within any state are neither dependent upon nor do they contribute to the operation of the foreign subsidiary corporations, and there is no basis for treatment of Anderson, Clayton & Co. as a world-wide unitary business. In spite of our pleadings and evidence supporting this position, California has assessed us on a world-wide unitary basis for all years since July 31, 1963. Because of our conviction of the equity of our position, we have vigorously contested all these assessments. The determination of the California Franchise Tax Board that Anderson, Clayton & Co. was engaged in a unitary business with its subsidiaries during the years in question is, in our opinion, without foundation in law or fact and borders on violation of constitutional protection.

The fact remains that we are incurring considerable additional expense attempting to protect our position. We do this fully realizing that in recent years the California Courts have generally held in favor of the State in most tax cases. Interstate and international businesses need the protection of Federal laws against the costly and wasteful litigation required to defend themselves in unfriendly state courts on such matters.

For example, assume that a U. S. parent has only on Mexican subsidiary and each conducts its entire business in its own country. While most states use a three factor formula, assume that a one factor sales formula is applied for purposes of state taxation in California.

	Total Sales	Sales in California	Taxable Income
U. S. Parent	$10,000,000	$1,000,000	$ 500,000
Mexican Subsidiary	10,000,000	-0-	500,000
	$20,000,000	$1,000,000	$1,000,000

In this case California taxable income based solely on the Parent would be $1,000,000/$10,000,000 times $500,000 or $50,000. In a California combination the taxable income would be $1,000,000/$20,000,000 times $1,000,000 or $50,000. California income is the same by either method because the profitability rate is the same for both companies. This is seldom the case.

Now assume we change only one factor, the taxable income of the Mexican subsidiary is $750,000. The California combination now reflects taxable income of $1,000,000/$20,000,000 times $1,250,000 or $62,500, an increase of $12,500. The same results may be obtained by changes in the factors.

Anderson Clayton

Statement - S. 1688
Subcommittee on Taxation and Debt Management

Several states have adopted the California method of combination obviously as a means of increasing the taxable income in their state. S. 1688 would correct this gross inequity in state taxation be requiring states to treat foreign corporations consistent with federal treatment.

Foreign source income

As time passes, more states seem to be attacking the problem of combined reporting by simply requiring the taxpayer to include foreign source income, especially dividends, in apportionable income.

Total taxes paid on dividends from our Mexican and Brazilian subsidiaries are in excess of the U. S. rate. These rates are as follows:

	Foreign Tax Rate on Profits	Taxes Withheld on Dividend	Total
Mexico	42%	21% X 58%	54%
Brazil	28%	25% X 72%	46%

The Internal Revenue Code provides a foreign tax credit, limited to the U. S. rate, on these dividends. However, when the states of Kansas, Illinois and Wisconsin, for example, tax the dividends, no deduction or credit is allowed for the foreign taxes paid. Considering the high foreign tax rates already paid on the dividends, any further taxes levied by the states creates a burden of double taxation.

We have protested assessments including foreign dividends in several states. The Hearing Officer usually reiterates that their state law does not allow a deduction for income taxes of other states or foreign countries. We surmise that the legislatures of these states did not contemplate taxation of foreign income when the laws were enacted and, therefore, had no reason to provide deductions or credits for the high rates of taxes in these foreign countries.

Some states already exclude foreign dividends from taxable income. Arizona excludes the dividends but during our last examination the agent included the gross-up required under Subpart F provisions of the Internal Revenue Code as income apportionable to Arizona. These are only samples of the many inconsistencies involved in state taxation.

Operations of our subsidiaries in foreign countries are neither dependent upon nor do they contribute to the operation in any state. There is no justifiable basis for treating any income from foreign sources as taxable by any state. California in years past, before their law specifically prohibited such, included the current income of foreign subsidiaries in apportionable income and in addition taxed dividends from these same subsidiaries. Taxation of the dividends was disguised by requiring that the interest expense deducted in the return be first reduced by any dividends not taxed by California. Thus, by disallowing interest expense as a deduction, the state effectively taxed the dividend. We favor the treatment of foreign dividends as prescribed by Sec. 7518(e) of the Bill.

Summary

Anderson, Clayton & Co. has testified at many hearings on taxation of interstate commerce beginning with HR 11798 before the House Judiciary Committee in 1966. If I may read a short quotation from the testimony given by Mr. John C. White in behalf of our Company from the Hearings on the Willis Bill in 1966:

Anderson Clayton

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"It seems to us that it should be made quite clear:

1. That the income of foreign subsidiaries whose operations are wholly foreign may not be included in the income to be apportioned to the States; and

2. That dividends received from such foreign subsidiaries are not to be included in such apportioned income.

. . . It is our position that income plainly earned outside the United States should not be attributed to any state. It has already been subjected to local and national taxes abroad where it is in fact earned."

We also testified before the Senate Judiciary Committee "grass roots" hearings in 1977 chaired by Senator Mathias. In the meanwhile, the States have made abortive attempts to tax corporations on a consistent basis from state to state. The original objectives of the Multi-state Tax Compact might have been attained except for the selfish interests of a few members. Several members of the Compact have withdrawn indicating failure of that organization to accomplish uniform taxation. Anderson, Clayton & Co. is quite willing to pay its share of the cost of operating state government where permits to do business have been obtained. However, income allocated to all states, including those who have no income tax, should not exceed one hundred percent. What we are looking for is a fair and equitable method of apportioning the total income. We believe the time has come to enact a federal law so that all states will treat taxpayers more fairly and consistently. We believe S. 1688 will at least accomplish part of the goal.

Sincerely yours,

Lyle Bethune
Lyle Bethune
Assistant Controller
& Director of Taxes

/cr

ARTHUR ANDERSEN &CO.

STATEMENT BY

ARTHUR ANDERSEN & CO.

ON

STATE TAXATION OF WORLDWIDE INCOME

This statement is submitted by Arthur Andersen & Co., an international firm of accountants with offices throughout the world. While the Firm has clients, both foreign and domestic, that would be affected by this legislation, this statement is not made on their behalf and the views expressed are those of the Firm itself.

We support S. 1688. The need for legislation that would limit application of the so-called unitary method of apportioning income for state tax purposes has become increasingly evident. Problems encountered in negotiating the recent United States-United Kingdom tax treaty, caused primarily by the efforts of some states to impose the unitary tax method on worldwide activities of business entities, have been well documented. At a time when international trade is increasingly important to the welfare of this country, both from the viewpoint of U. S. companies competing in world markets with companies from other countries, as well as the need to encourage foreign investment in the United States, legislation that would clarify the application of state tax systems to worldwide income is essential.

Unitary Worldwide Combination

A major purpose of this statement is to set forth some of the problems and inequities that have resulted for foreign corporations operating in the United States from application of the unitary method for state income tax purposes. At the outset, the basic issue that should be considered is the determination of the appropriate amount of profits earned within the jurisdiction of a state. This is the proper basis for taxation by that state.

Where business operations are carried on in more than one taxing jurisdiction, the unitary method makes arbitrary assumptions that an allocation of total business profits based on specific factors (sales, property, and payroll) will approximate the profits earned with a particular state. The accuracy of this method is often questionable for companies doing business solely within the United States, but its application to operations in other countries can create serious distortions.

Background of the Unitary Method

The unitary method of apportioning state taxable income originated in California. Almost forty years ago in a California Franchise Tax dispute (Butler Bros. v. McColgan, 315 U. S. 501 (1941)), definitional standards of what constitutes a unitary business were discussed. Subsequently, the unitary concept was expanded in Edison California Stores, Inc. v. McColgan (30 Cal. 2d (1947)).

In the 1970's, application of the unitary method by California (and other states) to worldwide business operations created an extremely complex state tax compliance problem for companies based outside the United States, as well as those based in the United States that conduct business outside the U. S. This is so in part because, beginning in 1970, foreign currencies were allowed to "float," and this has resulted in significant changes in their relative values.

The worldwide unitary combination approach is presently used by Alaska, California, Colorado, Idaho, Indiana, Montana, Oregon and Utah. Other states are believed to be considering adoption of the approach. Illinois utilized this method for a two-year period but discontinued its efforts when it left the Multistate Tax Compact.

Unitary Combined Report Complexities

Attached as Exhibit A is California's recently proposed "Guideline for the Preparation of Combined Reports Which Include Foreign Country Operations." These seven pages of detailed proposals illustrate the complex compliance problems faced by foreign based firms doing business in states which use the unitary method.

The entire worldwide "unitary" affiliated group must prepare tax accounting profit and loss statements in the currency of each foreign branch or corporation. The foreign statements are then to be adjusted to U. S. "generally accepted accounting principles," which must then be further adjusted to the tax principles of the California Revenue and Taxation Code.

After these steps have been taken, adjustment is to be made to the currency used by the parent company in maintaining its books and records. After making other allocation and apportionment calculations, the results are converted back to dollars for computation of the state tax liability.

Large international businesses based in Japan and Europe have stated that the compliance burden to convert the tax accounting information for literally hundreds of foreign affiliates to the California mode of compliance as set forth in the "Guideline" is grossly unfair and is out of all proportion to the business done in unitary states such as California.

The California worldwide unitary concept is further complicated in that the worldwide apportionment formula is applied to net taxable income of a unitary business. Many large corporations operate more than one unitary business, hence further burdensome and complex accounting is required to separate the results of the multiple corporate enterprise into each separate unitary business.

Smaller companies based outside the U. S. have found the accounting requirements to be even more onerous since they require a restatement of their accounting that is completely different from their regular method of accounting and tax reporting in foreign jurisdictions. Quite often, these companies do not have the accounting personnel to handle this compliance work.

Unitary Method - A Deterrent to the Creation of U. S. Jobs

Many foreign companies investigating potential plant locations in states that apply the unitary theory to worldwide operations have aborted their planned locations in these states, causing the loss of investment and jobs beneficial to the U. S. economy. These companies believe it unfair to incur a state tax based on their worldwide income when the U. S. Federal government does not impose such a tax. California is increasingly concerned about the possibilities of losing businesses to other states. In that regard, in early 1979, A. B. 525, a proposal somewhat similar to H. R. 5076, passed the California Assembly and is now before the California Senate.

Examples of Inequities Arising from the Unitary Method

Following are some examples illustrating inequities that can arise from worldwide application of the unitary method in computing state income taxes:

Example 1:

A bank located in California was acquired by a Japanese merchant bank. Prior to the sale, the California bank paid franchise tax based on its income which was wholly in California. After the acquisition the California franchise tax almost doubled on the same level of income, because the tax was based upon worldwide income apportioned to the state using the unitary business formula.

The operations of the Japanese bank were totally different outside the U. S., i.e., less labor and property intensive for a merchant bank operation compared to the retail branch banking customary in California. Thus, the three-factor formula's use of heavy property and payroll factors shifted a substantial portion of worldwide income to California, compared to the real income earned by California operations.

Example 2:

A California based engineering firm contracted to build a chemical plant outside the United States. As part of this contract, the U. S. firm agreed to train in California employees of the foreign firm which would operate the U. S. constructed facility.

The foreign based customer of the U. S. firm was subjected to California franchise tax under the unitary concept. Even though no income was generated in California, the presence of the payroll factor applied to worldwide income of the foreign firm subjected that company to California tax.

Example 3:

A foreign manufacturer operates in six areas of the world, including California. Due to higher California property values and payroll costs, the firm is less competitive pricewise and thus is less profitable in its California operation. The increased weight of the payroll and property factors results in an apportionment of more income to California than was actually earned by business operations in the state.

Example 4:

Another inequity arises where a foreign based company establishes a new operation in a particular state, and "startup" losses are generated. The apportionment formula may convert a loss operation to a profit due to application of the unitary factors.

States Have Ability to Deal with Abuse Situations

Most states have provisions in their tax laws which are similar to IRC Section 482, dealing with the artificial shifting of income and deductions. Further, the Internal Revenue Service shares information with most states as to Section 482 type adjustments which it makes in Federal audits. State tax authorities can use this information to prevent tax avoidance and abuses.

Exchange Controls Ignored

The U. S. tax law recognizes that earnings in blocked currency (exchange control) countries cannot be remitted to the parent. Such earnings are not taxed until remitted or currency restrictions are removed. The unitary method ignores this fact of business life and requires that income in these countries be included in worldwide income calculations.

Summary of Some Varying Worldwide Economic Factors

The unitary formula approach is, in concept, overly simplistic and not consistent with the real economic world. Distortions result because the unitary approach fails to take into account significant variables throughout the world:

1. Levels of inflation.

2. Exchange controls and blocked currency situations.

3. Levels of property values.

4. Levels of investment risk, and rates of return on investment.

5. Levels of labor and fringe benefit costs.

6. Different methods of accounting, i.e. plant and depreciation accounting, accrual accounting, and inventory accounting.

State Taxation of Dividends from Foreign Corporations

The second purpose of this statement is to comment on the provisions of S. 1688 that provide rules for state income taxation of dividends from foreign corporations and from U. S. corporations most of whose income is from foreign sources.

Identical legislation (H.R. 5076) is now being considered by the House Committee on Ways and Means. In testimony before the Ways and Means Committee, a Treasury representative commented that, among other things, the proposal for state taxation of dividends from foreign corporations would permit multi-national operations to be taxed more favorably than multi-state operations, thereby creating a tax preference for foreign investment.

If S. 1688 passes as proposed, multi-national operations would be taxed more favorably than multi-state operations in the sense that they will bear a lower state burden when earnings are repatriated. However, this does not mean that the bill creates an incentive to invest abroad to the detriment of domestic investment.

If taxes do affect the decision as to whether or not to invest, the primary tax incentive is created by the differential in underlying tax rates applying to operating income of a business entity, rather than by the tax rate on distributed income. This differential is the excess, if any, of U. S. taxes, both Federal and state, over foreign taxes, Federal and local, on undistributed income.

S. 1688 will affect only state taxes levied on distributed subsidiary income. As such, it may create an incentive to repatriate profits, or more correctly remove what is presently a disincentive to repatriate, by reducing the state tax imposed on profit distributions. This should have a positive effect on our country's balance of payments.

It seems to us important not to confuse two quite different incentives: (1) the incentive to invest; and (2) the incentive to repatriate resulting profits to the United States. S. 1688 would appear to have its primary effect on the latter, and only an incidental effect on the former.

The following example compares the tax burdens incurred by an investment which it is assumed will earn $100 before taxes. This example considers only taxes on foreign earnings that are not repatriated. It assumes a state tax rate of 8% and four levels of foreign taxes -- zero, 23%, 46%, and 56%. To the extent taxes can be said to create an incentive to invest, that incentive is quantified by comparing total tax burdens on the assumed pre-tax income.

	Total Tax Burden* Where Foreign Tax Rate Is			
	0%	23%	46%	56%
Investment in U.S.	50.32	30.32	50.32	50.32
Foreign investment	-0-	23.00	46.00	56.00

*Assumes Federal tax not deductible in calculating state taxes.

The tax burden on operating income (undistributed) in the United States will be greater than foreign at the first three levels, and would be greater for all foreign rates below 50.32%. The biggest element in this differential, however, is not state tax levels, which in this example would not be affected by S. 1688, but the difference between foreign and U. S. Federal tax rates.

S. 1688 would affect total taxes on foreign income if it is repatriated. As stated earlier, this proposal would eliminate a disincentive to repatriate profits, which should improve the U. S. balance of payments. The following table illustrates this point.

	Foreign Tax Rate Is			
	0%	23%	46%	56%
Under present law	50.32	49.33	50.32	59.52
Under S. 1688	50.32	48.16	46.00	56.00

*Assumes Federal tax not deductible in calculating state taxes.

As illustrated in the table, the differences in total tax burden between present law and S. 1688 where earnings are repatriated are relatively small, but the amendments under S. 1688 should encourage repatriation of profits to the United States.

Finally, taxes are only one factor in a company's decision to invest abroad or in the U. S. In most cases, they are not the major consideration. Accordingly, the impact of changes in state taxes on dividends like those proposed in S. 1688, which are small in relation to Federal tax burdens, would in most cases have little or no effect on investment decisions.

We urge the adoption of S. 1688 as the beginning of a long-needed review of the unitary method. The glaring inaccuracies and inequities of the application of that method to worldwide operations require immediate correction.

EXHIBIT A

CALIFORNIA FRANCHISE TAX BOARD

Proposed Guideline for the Preparation of Combined Reports Which Include Foreign Country Operations

I. Introduction

When any part of a unitary business has a nexus in California, the income and apportionment factors of the entire unitary business must be included in the combined report filed with California which is utilized to determine the income properly attributable to California sources. This requirement applies equally to businesses with operations solely within the United States, United States businesses with operations in foreign countries, and businesses based in foreign countries with operations within the United States. It applies whether the business operations are carried on by a single corporation or by multiple corporations.

Prior to 1970, the relative values of the currencies of the major industrial countries were the subject of international agreement and were, for the most part, stable. Beginning in 1970, currencies were allowed to "float," which has resulted in significant changes in their relative values. These changes have given rise to questions concerning the preparation of combined reports which include operations carried on in more than one country.

In choosing a translation method for the preparation of a combined report, the department has of necessity operated under constraints imposed by unitary theory and the requirement that taxpayers, identical but for the country of origin, be treated in a similar manner. These constraints and the efficient administration of the tax law have led the department to adopt the method commonly known as the profit and loss method for the preparation of combined reports.

II. Determination of Income

A. The income of a unitary business with operations in foreign countries will be computed in the following manner:

1. A profit and loss statement will be prepared for each foreign branch or corporation in the currency in which the books of account of the branch or corporation are regularly maintained.

2. Adjustments will be made to the profit and loss statement to conform it to the accounting principles generally accepted in the United States for the preparation of such statements except as modified by this guideline.

3. Adjustments will be made to the profit and loss statement to conform it to the tax accounting standards required under the California Revenue and Taxation Code.

4. The profit and loss statement of each branch or corporation, whether U.S. or foreign, will be translated into the currency in which the parent company maintains its books and records in accordance with paragraph II.C.

5. Business and nonbusiness income as determined under California law will be identified and segregated.

6. Nonbusiness income will be allocated to a jurisdiction on the basis of the rules provided for in the Uniform Division of Income for Tax Purposes Act as adopted by California. (§ 25123, et seq., California Revenue and Taxation Code.)

7. Business income will be included in the combined report prepared for the unitary business and will be apportioned on the basis of the appropriate formula for the business.

8. Income from California sources will be expressed in dollars in accordance with paragraph II.C. and the taxes computed accordingly.

B. For purposes of paragraphs II.A.2. and II.A.3. the following rules shall apply:

1. Accounting adjustments to be made to conform profit and loss statements to those utilized in the United States—

    (a) Include but are not limited to the following:

        (i) Clear reflection of income. Any accounting practice designed for purposes other than the clear reflection on a current basis of income and expense for the taxable year shall not be given effect. For example, an adjustment will be required where an allocation is made to an arbitrary reserve out of current income.

(ii) Physical assets, depreciation, etc. All physical assets, including inventory when reflected at cost, shall be taken into account at historical cost computed either for individual assets or groups of similar assets. The historical cost of such an asset shall not reflect any appreciation or depreciation in its value or in the relative value of the currency in which its cost was incurred. Depreciation, depletion, and amortization allowances shall be based on the historical cost of the underlying asset, and no effect shall be given to any such allowance determined on the basis of a factor other than historical cost.

(iii) Valuation of assets and liabilities. Any accounting practice which results in the systematic undervaluation of assets or overvaluation of liabilities shall not be given effect, even though expressly permitted or required under foreign law, except to the extent allowable under paragraph II.B.2. of this section. For example, an adjustment will be required where inventory is written down below market value.

(iv) Income equalization. Income and expense shall be taken into account without regard to equalization over more than one accounting period; and any equalization reserve or similar provision affecting income or expense shall not be given effect, even though expressly permitted or required under foreign law.

(b) Currency gains or losses on closed transactions are includible, but no adjustments shall be made, nor otherwise reflected, for unrealized gains or losses resulting from the restatement or re-valuation of assets or liabilities to reflect changes or fluctuations in currency values. A closed transaction is one where any foreign exchange position taken by a corporation has been terminated by exchanging the foreign currency for the currency in which the individual corporation maintains its books and records and normally conducts its business affairs.

2. The tax accounting adjustments to be made shall include, but are not limited to, the following:

   (a) Accounting methods. The method of accounting shall reflect the provisions of Section 24651 of the California Revenue and Taxation Code and the regulations thereunder.

   (b) Inventories. Inventories shall be taken into account in accordance with the provisions of Section 24701 through 24706 of the California Revenue and Taxation Code and the regulations thereunder.

   (c) Depreciation, depletion, and amortization. Depreciation, depletion, and amortization are to be computed in accordance with rules applicable to California taxpayers.

   (d) Elections.

      (i) Elections of all California reporting entities shall be made in accordance with applicable provisions of California law or regulations.

      (ii) Elections for entities which are not subject to taxation by California but are required to be included in the combined report for the unitary business shall be made by agreement of all entities required to report to California in accordance with applicable provisions of California law or regulation.

3. No adjustment shall be required under paragraphs II.B.1. and II.B.2. unless it is material. Whether an adjustment is material depends on the facts and circumstances of the particular case, including the amount of the adjustment, its size relative to the general level of the corporation's total assets and annual profit or loss, the consistency with which the practice has been applied, and whether the item to which the adjustment relates is of a recurring or merely a nonrecurring nature.

C. For purposes of determining income, necessary translations will be made at the following exchange rates:

1. Depreciation, depletion, or amortization shall be translated at the appropriate exchange rate for the translation period in which the historical cost of the underlying asset was incurred.
2. All other items shall be translated at the simple average exchange rate for the translation period unless there is a substantial fluctuation as described in paragraph IV.B. within the period, in which case a simple average of the month-end rates or weighted average may be utilized.

III. Computation of Factors

In computing the formula factors, the following rules shall apply:

A. Property Factor

1. Fixed assets will be valued at original cost as defined in Reg. 25130(a) and translated at the exchange rate as of the date of acquisition.
2. Rented property, capitalized at eight times its annual rental rate, will be translated at the simple average of the beginning and end of year exchange rate.
3. Inventories will be valued at original cost and will be translated at the exchange rate as of the date of acquisition.
4. For purposes of calculating the property factor of financial corporations, financial assets are translated at the year-end rate and are defined

as assets reflecting a fixed amount of currency, such as cash on hand, bank deposits, and loans and accounts receivable. Securities held or reasonably expected to be held for less than six months shall be translated at year-end rates. If a security is held, or reasonably expected to be held, for more than six months, it will be translated at the appropriate exchange rate for the translation period in which the historical cost of the asset is determined.

5. In computing the property factor, translation should normally be made into the parent company's currency in order to properly determine the percentage factor to be used.

B. Payroll and Receipts Factors

1. Translation is to be made at the simple average of the beginning and end of year exchange rates unless there is a substantial fluctuation, as described in paragraph IV.B.

2. Where the value of the foreign currency does fluctuate substantially, as described in paragraph IV.B., the exchange rate appropriate to that period shall be either (a) a simple average of the month-end rates, or (b) a weighted average taking into account the volume of transactions (reflected by the amount being translated) for the calendar months ending with or within that period.

3. In computing the payroll and receipts factors, translation should normally be made into the parent company's currency in order to properly determine the percentage factor to be used.

IV. Exchange Rates

A. For purposes of preparing combined reports, exchange rates may be derived from any source which is demonstrated to the satisfaction of the Department to reflect actual transactions conducted in a free market and involving representative amounts. In the absence of such demonstration, the exchange rates taken into account in computation of the earnings and profits of the foreign corporation are determined by reference to the free market rate set forth in the pertinent monthly issue of International Financial Statistics or successor publications of the International Monetary Fund or such other source as the Department may designate.

B. In general, the extent of fluctuation is substantial if the closing rate for any calendar month ending within the period varies by more than 10 percent from the closing rate for any preceding calendar month ending within the period.

V. Application of Guideline

In computing any of the income and factors required for a combined report, due regard will be given to the effort and expense required to obtain the necessary information; and in appropriate cases the Department, in its discretion, may accept reasonable approximations. Variations from the rules set forth above, particularly with respect to foreign-based corporations, may be allowed by the Franchise Tax Board in exceptional circumstances if applied on a consistent basis and where such variations do not result in a material difference in the reporting of income over time.

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July 7, 1980

Senator Harry F. Byrd, Jr., Chairman
Subcommittee on Taxation and Debt
Management
Committee on Finance
United States Senate
Washington, D.C. 20510

Attention Mr. Michael Stern, Staff Director

Dear Mr. Chairman:

We appreciate the opportunity to submit our written comments on S. 1688, which was the subject of a hearing conducted by the Subcommittee on Taxation and Debt Management on June 24, 1980.

Deloitte Haskins & Sells, an international accounting firm, has over 300 offices in 66 countries. We represent, in the U.S. and abroad, a substantial number of multinational clients, both U.S. and foreign based, which have operations in most, if not all, the states in the United States and in virtually every country of the world.

We support S. 1688, which would restrict any state or political subdivision thereof, from employing the so-called "unitary" or "worldwide combined reporting" methods of apportionment for purposes of taxing income earned outside the United States by foreign corporations. The Bill also limits the extent to which states and their political subdivisions can tax dividends received by a U.S. corporation from foreign corporations.

Our comments are directed primarily to the administrative problems and fundamental economic inequities which arise when the "unitary" or "worldwide combined reporting" methods are used to apportion or allocate income which is earned outside the United States to a state, and to then subject that income to taxation by the state.

I. COMPARISON OF THE UNITARY METHOD TO THE SEPARATE OR ARM'S LENGTH METHOD

Both the unitary and the separate or arm's-length methods have as their basic purpose the clear reflection of income earned by an affiliated group of entities in a particular jurisdiction, in situations where members of the group conduct business in many states or countries.

The separate accounting or arm's-length method of allocation is used by our government and the governments of most, if not all, of our major trading partners around the world to determine the tax liability of entities subject to taxation by them. Under this approach, the determination is made based on the books and records maintained by the entity, adjusted to reflect the differences between financial and tax accounting rules.

In contrast, the unitary method used by some states (most particularly California) ignores separate legal entities and requires the income of all entities which are members of a "unitary" group to be combined and reported as if earned by one entity. The total income of the group is then generally apportioned to the taxing jurisdiction by use of a formula based on property, payroll and gross receipts.

II. PROBLEMS AND INEQUITIES RESULTING FROM THE APPLICATION OF THE UNITARY METHOD TO FOREIGN OPERATIONS

a. The determination of the unitary group is subjective and very costly. The fundamental basis of the unitary, or worldwide, reporting system is that there is "unity" of ownership, use, or operation of the various entities in a group in the conduct of a single trade or business. There is, in other words, some contribution by each member of the group to the success of the trade or business--there is an interdependence between the various entities making up the group.

In establishing unity, or intercompany dependence, all facts and circumstances are to be considered. This involves the examination and weighing of a multitude of interrelationships. The California Franchise Tax Board, for example, has an eight-page list containing twenty detailed questions to serve as a basis for determining whether combining the worldwide operations of a particular group of affiliates is appropriate. Responding to each of these twenty questions requires the development of some very detailed information. Accumulating this information with respect to a group consisting of a few entities engaged in business solely within the U.S. may, while burdensome, be possible since the necessary records are readily available. However, gathering the data necessary to determine the includable or excludable entities, or groups of entities, with respect to multinational corporations with hundreds of separate entities engaged in business in scores of different countries is almost impossible.

Assume, for example, the plight of a taxpayer that is a multinational enterprise with 100 entities doing business worldwide. If it must consider 20 unitary factors for each entity in order to determine which are to be included or excluded from a combined return, it would have to examine 2,000 separate factors, based on information which would have to be accumulated in a number of different countries.

Moreover, regulations promulgated in California provide that a taxpayer may have more than one trade or business and, in such cases, must determine the business income attributable to each of them. Needless to say, making such a determination is extremely time consuming, and can result in a heavy financial burden being placed on the taxpayer. For example, there is a case which has been under examination by the California Franchise Tax Board for well over ten years without agreement as to which of the worldwide entities are within a unitary group.

b. The unitary method imposes unreasonable compliance and administrative burdens. In addition to the extremely difficult, if not impossible, task of determining which entities are members of a group under the unitary method, an even more formidable task is determining the taxable income of the members of the group. This follows from the fact that foreign parent companies, and non-U.S. subsidiaries of such companies, typically do not maintain their books and records in accordance with U.S. generally accepted accounting principles, and certainly not in accordance with U.S. or state tax accounting principles. Foreign accounting and financial records must be conformed to U.S. accounting standards and then to acceptable tax accounting principles.

At least one state, California, has issued proposed guidelines that purport to solve problems arising in this area. In general, the approach taken by these proposed guidelines approximates those taken in the income tax regulations under Section 964 of the Internal Revenue Code. However, to require a foreign corporation with any significant number of non-U.S. affiliates to make the necessary computations under such guidelines would impose an accounting burden that would literally demand man-years of effort. Most foreign companies have neither the data nor the manpower even to attempt to comply. Furthermore, producing the financial data sought by the tax administration of states employing the unitary method may, in some instances, violate foreign law.

The massive administrative burden that the unitary method imposes upon a taxpayer makes it impossible, or at least prohibitively expensive, to accumulate the data necessary to implement the method. In some cases, the actual tax imposed is only a fraction of the costs incurred by both the taxpayer and the state tax administration in accumulating the required data. As a result, many tax administrations are forced to rely on inaccurate financial data and to resort to arbitrary methods of computing the tax due.

c. The unitary method is based on faulty economic assumptions which create major distortions resulting, in most cases, in over-allocation of income to the states. The unitary method and the commonly used three-factor formula for apportioning income are based on the assumptions that:

- all members of the unitary group, once determined, are operating in a homogenous market where wages, sales price, profit margins and costs of business property are the same;
- there are no long-term differences in economic, political and social conditions;
- every dollar spent on wages, received from sales or invested in tangible property, will earn for each member of the unitary group the same income; and
- the actual profit earned by each member of the unitary group cannot be determined under arm's-length pricing of intercompany transactions.

We believe such assumptions are invalid for a number of reasons. First, in the United States, wages are generally higher than almost anywhere else in the world. Further, the wage apportionment factor does not include as wages the substantial costs of fringe benefits afforded to workers in foreign countries, which are often considerably higher than in the United States.

Second, property costs in the United States are generally substantially higher than elsewhere in the world, particularly with the advent of stringent pollution control requirements mandated by federal or state law.

Third, the sales or gross receipts factor can result in distortions because it ignores the difference in profit margins in different areas of the world because of local economic and political conditions. This follows from the fact that the risk factors in doing business abroad are many, involving not only possible nationalization or expropriation, but also other governmental regulations such as limitations on employee dismissal, plant relocations, importation of machinery and materials, exportation of finished goods, and currency exchange limitations. Faced with these economic and political hazards, multinational businesses will not venture into these countries without some assurance that their gross profit margins will be high enough to return their investments more quickly than in a more predictable political and economic environment. However, the fact that a dollar of sales in a foreign country may generate a greater profit than a dollar of sales in the U.S. is ignored in the sales factor. Each dollar of sales is deemed to earn the same profit. Thus, imposing a tax on a unitary basis could well result in a portion of the profit earned by a company in a foreign country being taxed by a state here in the United States.

The net result of these distortive factors is that formula apportionment under the unitary or worldwide combined reporting system results, in many more cases than not, in an over-allocation of net income to any state using such method. It is a miraculous coincidence when such method produces a fair and proper result.

III. SEPARATE ACCOUNTING IS PREFERABLE TO THE UNITARY METHOD

There are a number of sound reasons why states should be prohibited from applying the unitary method of apportioning income subject to tax and should be required to recognize separate accounting for multinational business entities.

a. The separate accounting concept is fundamental to the U.S. tax accounting system; it is used and recognized by most, if not all, the countries involved in foreign trade and is the basis for all recent bilateral treaties between the United States and foreign countries.

b. It avoids the difficulties inherent in determining which entities in the multinational group are members of the unitary group.

c. Separate accounting insures that record keeping and reporting requirements of multinational entities are kept within reasonable bounds, thus eliminating counterproductive and unnecessary administrative burdens.

d. The possibility of extra-territorial and/or double taxation is minimized.

IV. REBUTTALS TO USUAL ARGUMENTS OF PROPONENTS OF THE UNITARY METHOD

a. States will loose revenue. Perhaps the best answer to this is the comment by the late Dr. Laurence N. Woodworth, then Assistant Secretary of the Treasury, in the hearings before the Senate Committee on Foreign Relations on the tax treaties with the U.K., Korea and the Philippines in 1977:

> "if, in fact, there is a substantial revenue loss when an arms-length pricing standard replaces unitary apportionment, this may be an indication that unitary apportionment does, in fact, result in unjustifiable extra-territorial taxation."

b. Separate accounting and use of the arm's-length pricing method will lead to arbitrary, fictitious, and capricious results which are determined merely on the basis of corporate management accounting practice. This argument is generally directed towards the difficulties encountered in the apportionment of income and expenses. The answer to the argument is, of course, that the separate accounting, arm's-length method is, in fact, used and enforced by the federal government and many of our foreign trading partners.

The task of insuring that arm's-length pricing between domestic and foreign entities is fair and reasonable and has been assigned to the Internal Revenue Service. The IRS regularly audits most major multinational entities operating in the United States and the results of these audits are available to the states. If anyone doubts that the IRS is thorough, detailed and aggressive in its audits of intercompany transactions between U.S. and foreign entities, we would suggest that he talk to the director of taxes of any multinational corporation. Adoption of the separate accounting, arm's-length method would obviously demand fewer resources of the various state tax administrations since the Internal Revenue Service is already policing its application.

The states contend that they must be left free to use their unitary concept with foreign groups because the foreign groups will understate taxable income and that this understatement may not be disclosed by an Internal Revenue Service audit.

If these states are right that the foreign groups will understate income, we do not believe they have found the remedy for this problem in the unitary system. A foreign corporation that plans to understate income can do it as effectively under the unitary method as under any other method. Moreover, where the headquarters of the foreign corporation is in a foreign country, it is very difficult to see how a state can audit that entity any more effectively than the federal government can.

It is true, of course, that the states can have the same access to reports to shareholders of foreign parent corporations that they have with respect to U.S.-based parents, but this is true only when such reports are published. Many foreign corporations with significant income do not publish annual reports because they are closely held. In some countries the type of reports the states are accustomed to reviewing are not required by law even if the foreign parent's stock is traded on an exchange. Moreover, even when reports are available, it is highly unlikely that they will provide the detailed information on property, payroll and sales the state will require to compute the group's tax liability on a unitary basis.

Relying on federal enforcement and administration of the arm's-length method should at least provide data on U.S. operations which is reasonably correct.

c. The unitary tax system is not a disincentive to investment. While it is indeed true that the decision of a business entity to establish manufacturing or other business operations in a particular location will depend on many factors, such as proximity to markets, availability of trained or experienced personnel, transportation facilities, construction costs, availability and cost of employee housing, etc., the tax burden will inevitably also be a significant consideration. The tax burden can become a "swing" factor, particularly in the various industrial states of the U.S., because the other factors tend to be relatively equal. Most businesses generally do not allow tax consequences to dictate business decisions. However, we can cite a number of examples in which foreign-based businesses, and some U.S.-based businesses, have refused either to locate or to expand in California primarily because of their perception of the burden that the unitary method imposes.

V. CONCLUSION

The unitary method is inappropriate and unworkable in the case of multinational business entities. It subjects multinational taxpayers to an excessively expensive administrative burden which is not necessary for the accurate apportionment of income to the states of the United States. These time-consuming and costly determinations should not be tolerated at a time when increased business productivity is vital to the economic well-being of our nation.

The underlying assumption that each member of the multinational group is operating in a homogenous market without differing economic, political and social conditions and that the return on the property, payroll and gross receipts factors is equal in all countries simply does not exist in the real world. The end result, due to variations in the apportionment factors and profitability in different countries, is that foreign source income is frequently misallocated to the states and double taxation almost inevitably occurs.

In addition, and probably even more basically, the unitary method, when applied to multinational entities disrupts efforts to achieve harmony and uniformity in the taxation of commerce between the countries of the world and invites retaliation by foreign countries in which subsidiaries of U.S. companies operate.

> For these reasons we support the proposed federal legislation which would limit the authority of the states to tax income earned by a foreign entity in a foreign jurisdiction before such income is subject to tax under federal tax statutes.

Thank you for having given us the opportunity to present our views. We would be pleased to respond to questions regarding these written comments. Questions should be directed to either Mr. William O. Hetts, 44 Montgomery Street, San Francisco, California 94104 (415-393-4372) or Mr. Alexander Zakupowsky, Jr., 1101 15th Street, N.W., Washington, D.C. 20005 (202-862-3520).

Very truly yours,

Deloitte Haskins & Sells